Supreme Court, U. S.
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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1976

No. 76-6054

JERRY D. FRIDRICH, AGNES KIM, W. BRYANT WOOSLEY, HARRY L. WOOSLEY, III, and ELIZABETH M. WOOSLEY,

Petitioners,

v.

J. C. BRADFORD, J. C. BRADFORD, JR., J. C. BRADFORD & COMPANY, J. C. BRADFORD & COMPANY, INC., and LIFE STOCK RESEARCH CORPORATION,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit, entered in the above entitled case September 15, 1976.

OPINIONS BELOW

Neither the memorandum opinion of the District Court, printed in Appendix B hereto, *infra*, p. 43b, nor the opinion of the Court of Appeals, printed in Appendix B, *infra*, p. 1b, are yet reported.

JURISDICTION

The judgment of the Court of Appeals was entered on September 15, 1976, (App. B, p. 41b). This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

Plaintiffs, lacking information about a probable merger, sold securities at a loss in the over-the-counter market and sued broker-dealer-insiders who violated SEC rules 10b-5 and 10b-6 by trading personally and as principal market makers in the shares while concealing from the company's shareholders material merger information obtained in their capacity as directors and controlling shareholders in charge of negotiating the merger. Reversing the District Court's damage award, the Sixth Circuit held that in the absence of privity such trading insiders owed no duty of disclosure to plaintiffs enforceable in a private action and did not, as a matter of law, "cause" their losses.

1. When a security is traded on an impersonal public market, does SEC Rule 10b-5 impose on corporate insiders and market makers the duty not only to disclose material inside information privately to those with whom they trade directly but also, before trading, to disclose such information publicly to other buyers and sellers in the market?

2. If such a duty of public disclosure exists, may an investor, in the absence of privity of contract, recover damages under Rule 10b-5 against the corporate insider or market maker for breach of the duty on the ground that the investor suffered loss by trading in the market without knowledge of the material information?

3. Is there a private cause of action for damages under Rule 10b-6 in the absence of privity of contract where plaintiff sold securities in a market adversely affected by defendant's 10b-6 violation?

STATUTES AND REGULATIONS INVOLVED

Sections 10(b) and 28(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78bb(a), respectively, and Rules 10b-5 and 10b-6 issued by the Securities and Exchange Commission under the 1934 Act, 17 C.F.R. §§ 240.10b-5 and 240.10b-6, respectively, are set forth in Appendix A hereto.

STATEMENT OF THE CASE

A. Preliminary Statement

This case is a private civil action under SEC Rules 10b-5 and 10b-6. The United States District Court found that petitioners, plaintiffs below, were unaware of favorable information about a merger, and lost money when they sold their shares in the over-the-counter market during a period when respondents, as insiders, were concealing the merger information from the public while trading in the stock. The case was tried without a jury in the Middle District of Tennessee upon stipulation of facts, depositions and oral testimony. The District Court found the defendants guilty of violations of Rule 10b-5 and 10b-6 which proximately caused plaintiffs' injury and awarded damages in the aggregate amount of $361,186.85 (App. 81b-85b).

Concurring in the findings of fact of the District Court (App. 3b-9b), the Sixth Circuit Court of Appeals nevertheless reversed on the liability issue and remanded, instructing the District Court to enter judgment for the defendants (App. 41b). The Sixth Circuit ruled that in

the absence of privity of contract between the parties the defendants owed no duty of disclosure, enforceable in a private action, to plaintiffs and did not, as a matter of law, "cause" plaintiffs' losses. The Sixth Circuit rejected as inapplicable in impersonal market cases the materiality test of causation applied in *Affiliated Ute Citizens v. United States,* 406 U.S. 128 (1972) and expressly disagreed with the decision of Second Circuit in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (1974), holding under similar circumstances that a broker-dealer has a duty to disclose and that the *Affiliated Ute* rule of causation is applicable in impersonal market cases. The Court below concedes that its decision and the *Shapiro* decision are directly in conflict (App. 21b-22b). The decision of the Court below also conflicts with the duty of public disclosure of material inside information established in the landmark case of *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2nd Cir. 1968).

The result of the decision is to immunize from private civil liability under the securities laws brokers-dealers, marketmakers and corporate insiders who trade in the public market while concealing inside information from public investors, except where privity of contract is present. The decision will inevitably encourage such deception by recreant corporate officials and market operators who seek to profit at the expense of public shareholders.

B. Facts

Defendants, Bradford, Sr. and his son, Bradford, Jr., owned and managed the defendant, J.C. Bradford & Co., a broker-dealer in securities (App. 2b, 45b). These same defendants also owned a major share, controlled and were director of Old Line Life Insurance Company (App. 3b, 45b-47b). Bradford & Co. was principal market maker in

Old Line stock, trading in the stock in the over-the-counter market on a daily basis in order to maintain an active market (App. 6b-7b, 59b-65b).

On April 19, 1972, USLIFE Corporation made a proposal to Bradford, Sr. to acquire Old Line Life on the basis of an exchange of one share of USLIFE stock for one share of Old Line, an exchange involving approximately one million shares of USLIFE which were valued in the market at approximately $60 million (App. 5b, 138b). A USLIFE share was worth almost twice as much in the public market on the day of the acquisition proposal as an Old Line share. The market prices of the two stocks were: Old Line, $33; USLIFE, $61 (App. 5b, 50b). Bradford entered into an agreement with USLIFE which required USLIFE (1) to pay Bradford & Co., upon consummation of the merger, a "finder's fee" of 1% of the market price of the USLIFE stock exchanged (approximately $600,000), and (2) to negotiate the merger only with Bradford, Sr. or persons approved by him (App. 5b, 49b-50b).

For the next four months, beginning the day after USLIFE's acquisition proposal, Bradford Sr., his family, and a corporation owned by Bradford & Co. traded in Old Line stock on the basis of inside information, buying and selling 8,625 shares for a profit of $190,000 (App. 5b, 50b-51b, 60b). In addition, until the merger was consummated in December 1972, Bradford & Co., as market maker, also traded in the stock of Old Line on a daily basis while in possession of inside information, buying and selling approximately 150,000 shares for a profit of approximately $75,000 (App. 6b-7b, 59b-65b). Bradford, Sr. continued his market making operation during the period he was negotiating and putting into effect the merger with USLIFE. Upon consummation of

the merger, Bradford, Sr. received a profit of approximately $1.5 million in the exchange of his Old Line shares for USLIFE shares (App. 12b, 79b-80b).

The District Court found that the over-the-counter market in Old Line stock was "an essentially anonymous market like the market for securities maintained by the New York Stock Exchange and other securities exchanges" where the matching of buyers and sellers is substantially fortuitous (App. 4b, 59b-60b). Plaintiffs sold 13,818 shares in this market on June 13-15, 1972 during the period of trading and concealment by defendants (App. 81b-82b). Plaintiffs did not deal directly with defendants in connection with the sale of their shares (App. 7b).

The District Court found that the inside information about the merger in defendant's possession was material, that it would have significantly affected the decision of investors and the market in Old Line, if disclosed, and that plaintiffs' investment advisor would have advised against their sales had he known the facts (App. 71b, 74b-75b, 77b-79b). The District Court itemized in its findings four categories of important facts about the prospective merger which were concealed by defendants until November 1972 when the SEC, after investigation, approved the merger under §17(b) of the Investment Company Act of 1940 and made the information public (App. 77b-79b).

C. Proceedings Below

The District Court held that the defendants owed a duty to plaintiffs as investors to publicly disclose material information in their possession prior to trading. Upon the authority of *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra,* the District Court ruled that privity is not an element necessary to establish liability and that

the rule of legal causation applied in *Affiliated Ute Citizens v. United States, supra,* is also applicable in open market cases when a defendant's fraudulent concealment of information adversely affects the market (App. 72b-75b). In *Affiliated Ute,* the Court held that the "obligation to disclose and [the] withholding of a material fact established the requisite element of causation in fact." 406 U.S. at 154. Upon the authority of *Chris-Craft Industries v. Bangor Punta Corp.,* 426 F.2d 569 (2d Cir. 1970), the District Court also ruled that the continuous trading activity in Old Line stock by the defendants as market makers constituted *per se* market manipulation in violation of Rule 10b-6 because the defendants were then in the process of negotiating and putting into effect a public offering or distribution of Old Line and USLIFE securities to shareholders in connection with the merger (App. 75b-76b). The market making operation, continued by defendants during the distribution, carries with it the representation that the market price at which a security is being purchased is fair and not influenced by the market maker's deliberate concealment of important information, and the Court found that defendants' 10b-6 violation adversely affected the market.[1] As damages the District Court awarded the difference between the price ($33) each plaintiff received for the shares sold during the period of concealment and manipulation and the highest value ($58) reached by Old Line stock within a reasonable period (20 days) after the

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[1]The District Court said: "If Bradford had determined to cease his activities as a principal market-maker on April 19, 1972, the Court cannot but conclude that since he was recognized in the industry as a controlling figure in Old Line . . . a substantial import would have been felt in the marketplace and the buying public would have been alerted that something unusual was occurring" (App. 78b-79b).

disclosure of the information wrongfully withheld (App. 80b-83b).

On June 1, 1973, the defendants entered into a settlement agreement with the SEC consenting to the entry of a decree under which the defendants were found guilty of violating Rule 10b-5 and were ordered to disgorge $127,567.94 of their profits to persons who sold Old Line shares to Bradford & Co. and filed claim for reimbursement (App. 8b-9b). No actions other than this action and the SEC action have been brought. Other actions are now barred by Tennessee's two-year statute of limitation, Tenn. Code Ann. §48-1652 (1975 Supp.).

Reversing the District Court, the Sixth Circuit concluded that no liability exists in the absence of privity of contract between the parties because the defendants owed no duty of disclosure, enforceable in a private action, to plaintiffs and did not, as a matter of law, "cause" plaintiffs' losses: "Investors must be prepared to accept the risk of trading in an open market without . . . accurate information" (App. 22b), and "we are unable to agree," with the Second Circuit in *Shapiro v. Merrill Lynch, supra,* said the Court below, "that the duty to disclose is absolute, and that the plaintiff is injured when the information is denied him" (App. 21b). "Likewise," the Court said, "we are not persuaded, as was the Second Circuit in its decision in *Shapiro, supra,* that *Affiliated Ute Citizens v. United States, supra,*" provides the applicable test of causation in impersonal market cases (App. 22b). Despite the District Court's finding that the 10b-6 violation adversely affected the market to petitioners' detriment, the Sixth Circuit reversed, holding that "none of these defendants ever traded with plaintiffs;" and "accordingly, our conclusion that defendants' conduct in no way caused any loss to plaintiffs is equally

applicable to a theory of liability under Rule 10b-6" (App. 30b).

The Sixth Circuit's holding on liability was influenced by three arguments which recur in the opinion: (1) the imposition of such liability is harsh and gives rise to the possibility of excessive damages,[2] (2) would lead to the "unhealthy result" of restraining corporate officers from trading in the stock of their own company,[3] and (3) in the absence of privity plaintiffs lack standing.[4]

REASONS FOR GRANTING THE WRIT

1. *Conflict Among Circuits on Rule 10b-5 Issue.* – The decision of the court below in the instant case is directly in conflict with the decision of the Second Circuit Court of Appeals in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith,* 495 f.2d 228 (1974) This conflict is conceded in the court below both in the

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[2] "By so extending the liability of defendants here beyond that which has already been imposed through the SEC enforcement action, we believe we would be doing violence to the intent of the statute and rule, creating a windfall for those fortuitous enough to be aware of their nebulous legal rights, and imposing what essentially must be considered punitive damages almost unlimited in their potential scope." (App. 26b)

[3] "Imposition of unlimited liability . . . would have the effect of leading corporate officers, directors and other insiders to refrain from trading in the corporation with which they are associated. We cannot believe that this unhealthy result was intended by Congress . . . . " (App. 30b)

[4] "We have seriously considered but have declined to place final reliance upon any claim of lack of standing within the meaning of *Birnbaum, supra* . . . . In one sense our finding here that defendants' wrong caused no damage to plaintiffs amounts to a finding that that challenged action has not caused these plaintiffs 'injury in fact, economic or otherwise,' an essential element of standing . . . . " (App. 16b.)

majority and the concurring opinions (App. 21b-22b, 31b). The decision in the instant case is also in conflict with the duty of public disclosure of material inside information enunciated in *SEC v. Texas Gulf Sulphur Co.*, 401 F 2d 833 (2nd Cir. 1968), and with general principles of privity and causation applied in open market cases by the decisions of the Ninth Circuit in *Blackie v. Barrack*, 524 F.2d 891, 906-08 (1975), cert. denied, 45 U S.L.W. 3249 (October 5, 1976); and the Second Circuit in *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 426 F 2d 569 (1970), 480 F.2d 341 (1973), 516 F.2d 172 (1975), cert. granted, 44 U S.L.W. 3564 (Nos. 75-353, 75-354, 75-355, April 5, 1976).

Both the instant case and the *Shapiro* case raise the question whether private civil liability exists under Rule 10b-5 when the defendant, an insider trading in an impersonal market, practices deception by concealment of material information which, if disclosed, would affect the price of the security traded in the market. In both cases the insider was a broker-dealer with a close relationship with the issuer, and in both the plaintiff did not deal directly with the insider but asserts that the insider's deception breached a legal duty of disclosure to him and caused his loss by adversely affecting the market at the time he traded his shares. In *Shapiro*, the Second Circuit held that the insider owed and breached a legal duty of disclosure to plaintiff as an investor and that the requirement of legal cause is satisfied under the *Affiliated Ute* test of causation if the deception was material in the sense that it would influence reasonable investors in the market. In the instant case the Sixth Circuit held that the insider owes no such legal duty of disclosure, enforceable in a private action, to an insider with whom he does not deal directly and rejected the *Affiliated Ute* test of causation in impersonal market cases. Thus, the two cases are squarely in conflict, as the majority and concurring

judges in the court below expressly concede (App. 21b-22b, 31b).

The *Shapiro* case is the sequel to *Texas Gulf Sulphur, supra,* which imposed upon insiders, in an SEC enforcement proceeding under Rule 10b-5, the duty to disclose material information publicly to investors in the open market, or abstain from trading. The Sixth Circuit in the instant case held that this duty, if it exists at all, is enforceable only by the SEC and does not actually run to an injured public investor. The *Shapiro* Court said about this same argument that it "totally misconstrues our *Texas Gulf* rule" and "would make a mockery of the 'disclose or abstain' rule" because it ignores the fact that Rule 10b-5 "is based in policy on the justifiable expectation . . . that all investors trading on impersonal exchanges have relatively equal access to material information." 495 F.2d at 236. The instant case therefore raises fundamental unresolved questions respecting the existence and scope of the duties created by Rule 10b-5. This Court has not yet ruled on the duties of public disclsoure established in the landmark *Texas Gulf* case on the questions of privity in private actions based on insider trading raised in the *Shapiro* case and the instant decision.

In *Barrack, supra,* a nonprivity case based upon the issuance of a deceptive annual report, and in *Chris-Craft, supra,* a nonprivity case based upon deceptive statements and reports issued in a proxy contest, the Ninth Circuit and the Second Circuit, respectively, extended the *Affiliated Ute* rule of causation to deception by nondisclosure affecting impersonal market conditions. These cases therefore conflict with the ruling of the court below that the *Affiliated Ute* test of causation is inapplicable in impersonal market cases.

The *Chris-Craft* case, heard by this Court on October 6, 1976, is distinguishable from the instant case, however.

The instant case basically concerns the responsibilities of broker-dealers, specialist and other professionals with superior knowledge who maintain financial markets in securities, particularly their duties to disclose inside information to the average public investor in the securities market. The *Chris-Craft* case, on the other hand, presents the issues of privity and causation in the context of a contest for control between sophisticated corporate contenders. The instant case presents the classic example of insider trading at the expense of public investors which the 1934 Securities Exchange Act was expressly designed to combat, and the Sixth Circuit's abandonment of the duty to disclose to ordinary investors in the open market is antithetical to the purposes of § 10(b), as the Second Circuit pointed out in *Shapiro*. The Congressional purpose of the 1934 Act is stated by the House Committee in its report:

> No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings [sic] about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, *so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity.* Manipulation and dishonest practices of the market place thrive upon mystery and secrecy. The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values truth does find relatively quick acceptance on the market. That is why in many cases it is so carefully guarded. Delayed, inaccurate,

> and misleading reports are the tools of the unconscionable market operator and the recreant corporate official who speculate on inside information. (Emphasis added.)
>
> H.R. Rep. No. 1383, 73rd Cong., 2d sess. (1934)

The court below equates enforcement of the duty of disclosure described above with "draconian liability" for the corporate insider and "windfall profits" for the public investor (App. 3b, 26b), an attitude toward dishonest market operators hardly consistent with the Congressional attitude leading to the Act's adoption.

2. *Erroneous Interpretation of This Court's Decision in Affiliated Ute Citizens Case.* – In the *Ute* case, *supra*, this Court established the materiality test of causation in securities cases based on fraudulent nondisclosure. The court below rejected the *Ute* test on grounds that it applies only in face-to-face securities transactions. In both the instant case and *Ute*, the deception was in the form of concealment of material information which produced economic injury to uninformed sellers, and the deception was practiced by corporate insiders and market makers who stood in a fiduciary relationship to shareholders. The only difference is that privity was present in *Ute*. This Court recently reaffirmed the *Ute* test in *TSC Indus., Inc. v. Northway, Inc.*, 96 Sup.Ct. 2126, 2130 (1976), when the Court stated in the context of an exchange offer for acquisition of publicly traded securities, "[s]o long as the misstatement or omission was material, the causal relationship between violation and injury is sufficiently established." The court below appears to be the only court to hold that the *Ute* test applies only when privity exists. See the *Shapiro*, *Barrack* and *Chris-Craft* cases, *supra;* Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 *Harv.L.Rev.* 585 (1975) The court below has wrongly

interpreted this Court's decision in *Ute* and greatly circumscribed the scope of causation, and therefore liability, in 10b-5 cases.

3. *Importance of 10b-5 Issue.* – In which cases under Rule 10b-5 does the law require privity of dealing in order to establish a duty of disclosure; and in which nonprivity cases will proof of materiality of a deceptive practice establish, as in *Affiliated Ute*, the element of causation? Clearly these are important questions in the administration of the securities laws. The instant case raises these questions in the context of a trading insider who combines the duties of market maker, controlling shareholder, director and merger negotiator. There is no decision of this Court dealing with the questions of privity and causation in instances of securities fraud in the open market, although in *Blue Chip Stamps v. Manor Drug Stores*, 95 Sup.Ct. 1917, 1930 (1975), this court recognized that "in today's universe of [securities] transactions . . . privity of dealing . . . is the exception and not the rule." The rules stated by the court below, if left standing, will have a wide-ranging impact on the investment banking industry, encourage fraud by insiders and reduce investor confidence in the securities marketplace. These issues will come before the courts on a recurring basis. Their resolution is important for the proper functioning of capital markets.

4. *The Rule 10b-6 Issue.* – Likewise there is no decision of this Court dealing with the important question of the existence and scope of private liability under Rule 10b-6 or the question whether privity of dealing is necessary for recovery against a broker-dealer-market-maker who trades in a security while participating in the distribution of the security by offering it to stockholders of another corporation in connection with a

merger. Similar questions are now before the Court in the petitions for certiorari granted in the *Chris-Craft* case *supra*. The ruling of the court below requiring privity in order to establish legal duty and causation in private actions under Rule 10b-6 conflicts with the decision of the Second Circuit in *Chris-Craft* and with the position of the Securities and Exchange Commission, as stated at page 185 in its Brief, filed September 3, 1976, in the *Chris-Craft* case, "the class of persons intended to be protected from the effects of the manipulative conduct encompassed within Rule 10b-6 includes all users of the markets for the relevant securities."

5. *Decision Below Conflicts with Scholarly Opinion* – The decision of the court below requiring privity in order to establish duties of disclosure and causation conflicts with the views of the American Law Institute and scholars in the field. The Sixth Circuit's ruling on Rule 10b-6 conflicts with the proposed *ALI Federal Securities Code* (Tent. Draft No. 2, March 1973), drafted by Professor Louis Loss; see Part XIII, "Deceptive and Manipulative Acts," § 1408(d) establishing civil liability for such conduct. The Sixth Circuit's ruling on Rule 10b-5 also conflicts with the proposed *ALI Securities Code*; see § 1303 "Insiders' Duty to Disclose When Trading" and § 1402(b) establishing civil liability for breach of such duty in open market cases. Many law journal articles express views contrary to the decision of the court below; see, e.g., Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5, 88 Harv.L Rev.* 584 (1975), and the compilation of articles cited in footnote 7 thereof.

CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to the United States Court of Appeals for the Sixth Circuit.

Respectfully submitted,

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APPENDIX

APPENDIX A

Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 28(a) of the 1934 Act, 15 U.S.C. § 78bb(a), provides:

> (a) The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder.

Rule 10b-5 under the 1934 Act, 17 C.F.R. § 240.10b-5, provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Rule 10b-6 under the 1934 Act, 17 C.F.R. § 240.10b-6, provides in pertinent part:

> (a) It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10(b) of the act for any person,
>
> (1) Who is an underwriter or prospective underwriter in a particular distribution of securities, or
>
> (2) Who is the issuer or other person on whose behalf such a distribution is being made, or
>
> (3) Who is a broker, dealer, or other person who has agreed to participate or is participating in such a distribution, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, either alone or with one or more other persons, to bid for or purchase for any account in which he has a beneficial interest, any

> security which is the subject of such distribution, or any security of the same class and series, or any right to purchase any such security, or to attempt to induce any person to purchase any such security or right, until after he has completed his participation in such distribution. . . .

No. 74-1902

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

JERRY D. FRIDRICH, AGNES KIM, W. BRYANT WOOSLEY, HARRY L. WOOSLEY III, and ELIZABETH M. WOOSLEY,

Plaintiffs-Appellees,

v.

J. C. BRADFORD, J. C. BRADFORD, JR., J. C. BRADFORD & COMPANY, J. C. BRADFORD AND COMPANY, INC., and LIFE STOCK RESEARCH CORPORATION,

Defendants-Appellants.

APPEAL from the United States District Court for the Middle District of Tennessee.

Decided and Filed September 15, 1976.

Before: CELEBREZZE, PECK and ENGEL, Circuit Judges.

ENGEL, J., delivered the opinion of the Court, in which PECK, J., joined. CELEBREZZE, J., (pp. 31-40) filed a separate concurring opinion.

ENGEL, Circuit Judge. On April 27, 1972 J. C. Bradford, Jr. purchased 1,225 shares of common stock of Old Line Life Insurance Company (Old Line). The shares were purchased on inside information Bradford, Jr. had received on a tip from his father. The shares were purchased on the over-the-

counter market from J. C. Bradford and Co., a Nashville brokerage firm of which Bradford, Jr. and his father are managing partners. Subsequent to the purchase, Old Line stock increased in value and on July 27, 1972, Bradford, Jr. sold the 1,225 shares, reaping a profit of $13,000 on the transaction.

The Securities and Exchange Commission investigated Bradford, Jr.'s stock transaction. As a result of a consent decree entered into between the Commission and Bradford, Jr., he was required to disgorge the entire $13,000 profit, was permanently enjoined from any further violation of § 10(b) of the Securities Exchange Act of 1934[1] and Rule 10b-5,[2] and was suspended from performing any business activities as a broker-dealer for twenty working days.

Thereafter plaintiffs filed this civil action, alleging that Bradford, Jr.'s trading activities violated Rule 10b-5. By the judgment of the district court appealed from here, Bradford, Jr. has been rendered jointly and severally liable to plaintiffs for the sum of $361,186.75. He has been held liable, although plaintiffs never sold their stock to him or his

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[1] It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
June 6, 1934, c. 404, § 10, 48 Stat. 891.

[2] It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
(Sec. 10; 48 Stat. 891; 15 U.S.C. 78j) [13 F.R. 8183, Dec. 22, 1948, as amended at 16 F.R. 7928, Aug. 11, 1951]

associates, nor did they sell on the same day or even in the same month in which he bought. There was no proof that Bradford, Jr.'s trading activities had any impact upon the market price of Old Line stock or upon plaintiffs' decision to trade in it. As we read the district court judgment, Bradford, Jr.'s liability would have been the same even though he had purchased only five shares of Old Line and made a profit of less than $53.00.

While Bradford, Jr. is only one of five defendants in this appeal, we have focused on his liability at the outset in order to illustrate the "Draconian liability"[3] to which persons who trade on inside information may be subjected to under the district court's interpretation of Rule 10b-5. Because we conclude that under the circumstances of this case imposition of civil liability constitutes an unwarranted extension of the judicially created private cause of action under Rule 10b-5, we reverse the judgment of the district court.

I.

Of the five defendants named[4] in the district court action, the dominant figure was James C. Bradford (Bradford). In 1961, Bradford put together a syndicate to purchase a controlling block of Old Line stock, which the syndicate continued to own through 1972. After the purchase, Bradford became a director of Old Line and upon his retirement as a director, was succeeded by Bradford, Jr., who remained a director until August 1972. Approximately one a year Bradford was visited in

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[3] *See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F. 2d 228, 242 (2d Cir. 1974).

[4] The five named defendants are J. C. Bradford, J. C. Bradford, Jr., J. C. Bradford and Co., J. C. Bradford & Co., Inc., and Life Stock Research Corp. J. C. Bradford & Co., Inc. is a corporation wholly owned by the partners of Bradford & Co. and controlled by Bradford & Co. as a partnership entity. Life Stock Research Corp. is a registered investment company. During 1972, and for several years prior thereto, J. C. Bradford & Co., Inc. owned 81% of the voting capital stock of Life Stock. The defendants owned as much as 17% of the outstanding stock of Old Line during the period in question.

Nashville by Forrest Guynn, president of Old Line, who gave Bradford a personal report on the affairs of the company. After the 1961 purchase, Bradford & Co. became the principal market-maker of the stock.[5]

Prior to 1972, Old Line was considered a prime target for merger or takeover in the insurance industry and Bradford, because of his relationship with Old Line, was often approached by companies interested in a takeover.

In October, 1971, Gordon E. Crosby, chairman of U. S. Life Corporation (USLIFE), a New York based insurance company, contacted Bradford concerning the possible acquisition of Old Line by USLIFE. Crosby was advised by Bradford that no offer would be considered unless it involved an offer of at least $50 per share for Old Line stock. Since Old Line had a market price of only $24 per share at that time, Crosby did not pursue the negotiations.

On April 19, 1972 Crosby telephoned Bradford and stated that he was then in a position to work out a deal at better than $50 per share of Old Line stock. Crosby, in effect, proposed an acquisition on the basis of one share of USLIFE stock for one share of Old Line. In a letter of April 21, 1972, Crosby agreed to negotiate the acquisition only with Bradford and agreed to pay Bradford a finder's fee equivalent to 1% of the fair market value of the USLIFE stock exchanged for the Old Line stock. On April 19, 1972 the closing bid price for Old Line stock was $33 per share and the closing price for USLIFE on the New York Stock Exchange was $61 per share.

On April 21, 1972, after his conversations with Crosby, Bradford caused to be purchased for the account of his wife 2,000 shares of common stock of Old Line, at an average price of about $34 per share. Between April 21 and April 26, Bradford made several purchases totalling 5400 shares of Old Line for the account of Life Stock Research Co. (Life Stock) at an average price of about $36 per share. On April 27, 1972, after hearing of Bradford's conversations with Crosby, Bradford, Jr. purchased 1,225 shares of common stock of Old Line at $37 per share. Prior to their April, 1972 purchases, the Bradfords had made only one purchase of Old Line stock in the past eight years, that in 1969.

On May 15, 1972 Bradford called Crosby and told him that he had spoken to Forrest Guynn, chief executive officer of Old Line. Bradford reported that Guynn was interested in having serious negotiations concerning the merger. Because Old Line was going to declare a 20% stock dividend, the ratio of exchange would have to be changed to 8/10 of a share of USLIFE per one share of Old Line, but Bradford saw this as presenting no problem.

[5] The market in Old Line stock was described by the district court in its findings of fact:

> The market in Old Line stock was maintained in the over-the-counter market, an essentially anonymous market like the market for securities maintained by the New York Stock Exchange and other securities exchanges. The New York Stock Exchange is an auction market so that for a New York Stock Exchange listed security, there is a specialist or market-maker on the floor of the Exchange who handles the transactions in a particular stock. A trade is consummated when a broker with an order from his customer to buy or sell a security goes to the specialist who either matches the order against one or more buy or sell orders placed with him by other brokers, or, if necessary, if there is an imbalance in the market, the specialist buys or sells the stock for his own account in order to make the market. The specialist is obligated to buy and sell securities at quoted prices in order to maintain the market in a security. In the over-the-counter market, a market in a security is maintained in basically the same way as on an Exchange, except that in the over-the-counter market, there may be more than one specialist or book in the stock. This specialist is called a market-maker and he offers and obligates himself to buy and sell a particular security at quoted prices. Such a specialist or market-maker advertises his quotations by placing bid and asked quotations on the security in the "NASDAQ" system or the "pink sheets" published daily by the National Quotations Bureau. A broker with an order to buy or sell a security in the over-the-counter market, as on the New York Stock Exchange, would contact a specialist or market-maker. This would usually be done by telephone instead of on the floor of the exchange. The market-maker would buy or sell the security based on his quotations, adjusting his prices on the basis of the supply and demand for the stock. The market-maker in the over-the-counter market, just as on the New York Stock Exchange, is risking his own capital, seeking to make a profit from his trading activity by judging the demand and supply of the stock and the direction of the price.

Negotiations toward the merger continued in June, 1972. Bradford's finder's fee agreement granting him the right to receive 1% of the fair market value of the USLIFE stock exchanged was signed on June 26. Crosby of USLIFE and Guynn of Old Line met on June 28-29 and issued a press release on June 29 in which the terms of the acquisition offer were stated,[6] without mention, however, of the finder's fee. The June 29, 1972 press release was the first public announcement of the proposed merger. On July 7, 1972, Guynn, with the authorization of Old Line's Board of Directors, agreed in principle to the merger of Old Line and USLIFE. On July 11 a press release announcing the agreement in principle was issued and this was delivered to stockholders on July 14. Because of problems concerning SEC approval of the merger, the proposed date of the merger, September, 1972, had to be delayed.[7] Also, because the SEC would not approve Bradford's finder's fee without a hearing, Bradford waived his fee in return for an increase in the exchange rate on the stock from 0.8 to 0.808 of the USLIFE stock per share of Old Line. After an investigation of several months, the SEC approved the merger on November 20, 1972 and on December 28, 1972, after approval by Old Line's stockholders, the merger became effective.

Bradford and Co. was the principal market maker in Old Line stock throughout 1972, purchasing 169,054 shares and

[6] The press release of June 29, 1972 issued by Crosby concerning the proposed acquisition of Old Line by USLIFE was reported in the Wall Street Journal on June 30, 1972. That story read in part:

> Reached in Milwaukee, Forrest D. Guynn President of Old Line Life, said he "could be" surprised at the offer. "I haven't had that much opportunity to study USLIFE's figures at all," he said, stating that for that reason he couldn't comment further.
>
> Under the terms presented to Old Line, USLIFE would acquire each Old Line outstanding share for 0.8 share of USLIFE common. The transaction would involve 1,036,000 USLIFE shares, the company said.

[7] Old Line and USLIFE determined that the merger could not be consummated unless the SEC entered an order pursuant to § 17(b) of the Investment Company Act of 1940, 15 U.S.C. § 80(a)-17(b), exempting the merger from the provisions § 17(a) of the Act.

selling 170,685 shares, for which it was paid commissions in the amount of $103,214. Approximately $75,000 of this profit was a result of trading activity in Old Line during the months of April through December, 1972.

On July 31, 1972, Bradford, Jr. sold the 1,225 shares of Old Line stock he had purchased in April 1972 at a profit of $13,000. On August 24, 1972, Life Stock sold the 5400 shares purchased for it in April, realizing a profit of approximately $103,000 on the transaction. The 2,000 shares Bradford had purchased for his wife were not sold prior to the merger, but on the last business day prior to the merger there was an unrealized appreciation in the value of those shares amounting to approximately $74,000 based upon the bid price of Old Line stock on that date.[8]

Two of the plaintiffs (Fridrich and Kim) bought stock in Old Line in May, 1972 and sold the stock in June at a slight profit.[9] The stock was purchased from a broker, Ken Schoen, and was sold on his advice. These transactions did not involve Bradford or any of his associates. The other plaintiffs (the Woosley family) purchased their stock from Bradford & Co. in 1967 but sold in June, 1972, through Schoen and on his advice. Schoen testified he would not have advised clients to sell their stock had he been aware that Bradford and Old Line were negotiating an agreement with USLIFE to effect a merger. Schoen did not have any information concerning the proposed merger until mid-July, 1972. He did not advise the plaintiffs to repurchase Old Line stock.

[8] Had the defendants sold the Old Line stock which they had purchased on June 29, 1972, the date upon which the press release containing the first public information concerning the merger was issued, their profits would have been lower. Based upon the bid price for Old Line on that date, Bradford, Jr. would have realized a profit of $13,475, Life Stock a profit of $64,800 and Bradford a profit of $27,750, for a total profit of $96,025.

[9] Although these plaintiffs sold their shares at a price lower than that at which they purchased it, they made a slight profit on the transaction due to the 20% stock dividend declared in the interim between their purchase and sale.

Meanwhile the SEC commenced an investigation of the transaction. Hearings were held before the Commission in early November, 1972 and on November 10, 1972, the SEC filed a Rule 10b-5 enforcement action against Bradford, Bradford, Jr., Life Stock, Bradford & Co. and Bradford & Co., Inc. in the United States District Court for the Southern District of New York.[10] The action was terminated by the filing of a stipulation of settlement and the entry of a consent judgment on June 1, 1973. That judgment permanently enjoined the defendants from directly or indirectly violating Section 10(b) in connection with the purchase or sale of securities issued or to be issued by Old Line. It further ordered that a fund created by a November 27, 1972 escrow agreement should be held and dispersed to such persons as should file their claims under the terms thereof.[11] Those entitled to file claims were defined by the judgment as:

> (a) Any person other than a customer of J. C. Bradford and Co. who sold any shares of Old Line to J. C. Bradford and Co. in the period from April 21, 1972 to April 27, 1972, and
>
> (b) Any customer of Bradford & Co. who sold any shares of Old Line to J. C. Bradford and Co. in the period of April 21, 1972 to June 29, 1972.

The judgment provided that to the extent not objected to, the escrow agent should promptly, after August 31, 1973, "pay all claimants the difference between the price at which claimants sold Old Line stock to J. C. Bradford and Company and $40 per share after appropriate adjustment for stock

[10] *Securities and Exchange Commission* v. *James Cowdon Bradford, et al.*, No. 72 Civ. 4776 (S.D. N.Y. 1972).

[11] After the SEC commenced its enforcement action on November 10, 1972, Bradford, Bradford, Jr. and Life Stock entered into an escrow agreement whereby they deposited with the Third National Bank in Nashville certain funds to be disbursed to any claimants found to be entitled thereto under any judgment entered against these defendants.

dividend." In execution of the provisions of the judgment, the escrow agent paid to 25 claimants who qualified under Subsection A of the judgment a total of approximately $97,-200. The escrow agent further found that between June 7 and July 31, three dealers in securities had filed claims with him under Subsection B and were entitled to be paid approximately $31,000. Thus, by the judgment as finally carried out, the defendants agreed to and paid a total of $127,567.94, an amount $15,629.69 in excess of the amount then in the escrow fund.[12]

By the earlier stipulation of settlement, Bradford and Bradford Jr. consented to the entry by the Commission of orders suspending them for a period of 60 and 20 business days respectively from being associated with a broker, dealer, or investment advisor.

II.

On April 25, 1973 a complaint was filed in the United States District Court for the Middle District of Tennessee by plaintiffs Fridrich, Kim and the Woosleys. The complaint charged defendants with violation of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 because of their trading in Old Line stock while in possession of material inside information. The complaint also charged defendants with violation of §§ 9(e), 10(b) and 15(c) of the Securities Exchange Act, alleging that defendants had manipulated the market in Old Line stock by virtue of their position as market makers of the stock.

The case was submitted for decision on the merits to the district judge upon several stipulations of fact and upon certain other evidence including depositions of the principals taken in the hearings before the Securities and Exchange Commission.

[12] The $15,629.69 was paid by Bradford & Co. The record does not reflect whether it recouped any part thereof from the other defendants.

Without making any particular distinction between the defendants, the district court found that all had violated Rule 10b-5 by trading in Old Line stock while in possession of material inside information, without first disclosing the information to the investing public trading in the same market. The court also found that Bradford, Bradford, Jr. and Bradford and Co. had violated Rule 10b-6[13] by virtue of their continuous trading activity in Old Line stock from April through November, 1972, the period in which the terms of the merger were being established.

Turning to the issue of damages, the district judge made this finding:

> Each plaintiff sold Old Line stock during the period of nondisclosure and is therefore entitled to damages as a result of defendants' nondisclosure in violation of Rule 10b-5 and market-manipulation in violation of Rule 10b-6. The measure of damages is the difference between the price each plaintiff received for his shares sold during the period of nondisclosure and manipulation and the highest value reached by Old Line stock within a reasonable time after the tortious conduct was discovered and

[13] Rule 10b-6 provides in relevant part:

> (a) It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10(b) of the act for any person,
>
> (1) Who is an underwriter or prospective underwriter in a particular distribution of securities, or
>
> (2) Who is the issuer or other person on whose behalf such a distribution is being made, or
>
> (3) Who is a broker, dealer, or other person who has agreed to participate or is participating in such a distribution, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, either alone or with one or more other persons, to bid for or purchase for any account in which he has a beneficial interest, any security which is the subject of such distribution, or any security of the same class and series, or any right to purchase any such security, or to attempt to induce any person to purchase any such security or right, until after he has completed his participation in such distribution. . . .

The complaint itself made no mention of Rule 10b-6.

> the disclosure made of the information wrongfully withheld. The highest bid value reached by Old Line stock within a period of 20 days following the SEC's action on November 10, 1972, disclosing the defendants' wrongful conduct on the SEC's action giving approval to the merger on November 20, 1972, was $58 a share reached on November 21, 1972 and on December 8, 1972.

Based upon this measure of damages,[14] the district judge entered judgment against defendants and in favor of plaintiffs in the aggregate amount of $361,186.75. The district judge thus held that insiders who buy in an impersonal market using material inside information can be liable to sellers in an impersonal market who sold without knowledge of the inside information, even though it was undisputed that the insiders did not purchase the shares sold by the plaintiff sellers. In addition, he held that insiders who continue normal market making activities[15] in the stock in a corporation while nego-

[14] It can be seen that the district judge thereby determined that the period of non-disclosure did not end with public announcement of the merger itself, but continued to include what the court conceived to be the period of non-disclosure of Bradford's abortive efforts to obtain a finder's fee.

[15] In their complaint, plaintiffs charged that defendants had actively manipulated the market in Old Line stock:

> As a result of their dominant position as market-maker and specialist in the stock of Old Line, the defendants, during the period of their illegal nondisclosure and trading activity, influenced the price of the stock to their own advantage and plaintiffs' detriment by holding the market price at a low level after an initial rise in the price of the stock caused by their illegal insider purchases during April, 1972. By reducing the price level of the stock, the defendants created the impression that the market price was declining, at a time when the merger was imminent and the real value of the stock was almost double the artificial market price maintained by defendants, thereby inducing stockholders in the position of plaintiffs to sell before a further price decline.

The district court, in finding a violation of Rule 10b-6, did not find such active market manipulation as described in the complaint above. Rather, it concluded that the merger negotiated here constituted a distribution of securities under Rule 10b-6 and that it was market manipulation for defendants as broker-dealers to trade in the securities while participating in the merger negotiations. We have found

tiations concerning a merger of that corporation are ongoing, can be liable to persons trading in the stock, even though those persons did not trade with the market maker. Finally, on the issue of damages, the district court held that such defendants can be liable in damages in an amount far in excess of the profits they made from the illegal purchases of stock from their market making activities.[16]

We have set down the complicated facts before the district court in considerable detail to illuminate the setting in which the issues arise. We think, however, that the issues themselves are more simply stated. In the final analysis, the question is how far the courts are to extend the private civil right of action under Section 10(b) and Rule 10b-5 when the alleged violation is the unlawful use of inside information and the stock involved is traded upon an impersonal market.

III.

Section 10(b) of the 1934 Act does not expressly provide a civil remedy for its violation. As noted by Justice Rehnquist

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no evidence in the record to support the charge that the defendants manipulated the price of Old Line stock as described in plaintiff's complaint.

[16] Plaintiffs have contended on this appeal that defendants' total profit on their illicit transactions was well in excess of the amount which plaintiffs were awarded as damages. This contention stems from the fact that defendant Bradford negotiated the merger between USLIFE and Old Line, the result of which was to exchange 60,000 of his own shares of Old Line for USLIFE shares. As a result of the exchange, the value of Bradford's investment increased by over $1,500,000.

The district judge found that Bradford's conduct in negotiating the merger which increased the value of his investment itself constituted unlawful trading activity in Old Line stock. We disagree. Bradford had owned the shares in question for several years. We do not think that he was precluded from helping to negotiate a merger which had the effect of increasing the value of the investment of *all* shareholders in Old Line. Such a rule would preclude corporate officers or insiders who own stock in the corporation from participating in merger negotiations even though a merger might be in the best interests of the corporation. We have found no authority for such a proposition and consider it to be against the sound public policy of encouraging stock ownership by corporate officers. We thus hold that Bradford's participation in merger negotiations did not constitute a violation of Rule 10b-5 even though an effect of that merger was to increase the value of his investment in Old Line by a substantial amount.

in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 729-730 (1975), there is no indication that Congress at the time it passed the 1934 Act considered the issue of private suits under § 10(b). Nor is there any indication that the Securities and Exchange Commission, in adopting Rule 10b-5, considered private civil actions under the rule. Nevertheless, since the seminal decision in *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512 (E.D.Pa. 1946), in which a private civil remedy under § 10(b) was first judicially implied, a steady expansion of that remedy by the federal courts has occurred.[17]

In *Kardon, supra*, the court found an implied cause of action under Rule 10b-5 based upon the law of torts. Citing § 286 of the Restatement of Torts, the court noted that "[T]he disregard of the command of a statute is a wrongful act and a tort". 69 F. Supp. 512, 513. The court found judicial support for its decision in *Texas and Pacific Ry.* v. *Rigsley*, 241 U.S. 33 (1916), in which the Supreme Court for the first time recognized an implied private right of action for violation of a federal regulatory statute:

> . . . disregard of the command of the statute is a wrongful act, and where it results in damage to one of the class for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is implied . . .

241 U.S. 33, 39.

Since *Kardon, supra*, courts have allowed a private right of recovery based upon a tort theory of liability. *See, e.g., Mitchell* v. *Texas Gulf Sulphur Company*, 446 F.2d 90, 97 (10th Cir. 1971) *cert. denied* 404 U.S. 1004, 405 U.S. 918

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[17] As noted by Justice Rehnquist in *Blue Chip Stamps, supra*, "When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn."

421 U.S. 723, 737.

(1972), A. Bromberg, Securities Law: Fraud-SEC Rule 10b-5, § 2.4(1)(2) at 30 (1969) (hereinafter Bromberg). Under the tort theory, while the private right of action is viewed as a necessary supplement to SEC action, *cf. J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964), and as encouraging enforcement of the provisions of the Securities Exchange Act, its primary purpose is to compensate plaintiffs for damages caused by defendant's illegal acts.[18]

IV.

Few early cases brought under § 10(b) and Rule 10b-5 dealt with non-disclosure by insiders trading in the open market.[19] Development of the law in this area is largely traceable to the "abstain or disclose rule" developed in *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) *cert. den.* 394 U.S. 976 (1969).[20] This was an SEC enforcement action brought under 15 U.S.C. §§ 78u and 78aa against Texas Gulf Sulphur Co. (TGS) and thirteen individuals who, it was charged, purchased TGS stock or calls on the strength of undisclosed inside information of favorable exploratory drilling results by the company near Timmins, Ontario. Noting that an important purpose of Rule 10b-5 was to help insure that all persons trading on the securities markets have relatively equal access to material information, Judge Waterman observed:

> The essence of the Rule is that anyone who, trading for his own account in the securities in a corporation has "access, directly or indirectly to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage

[18] *See* Comment, *Damages to Uninformed Traders for Insider Trading on Impersonal Exchanges*, 74 Colum. L. Rev. 299, 304 (1974).

[19] *See* Bromberg, *supra*, § 7.4 n. 98.

[20] The Texas Gulf Sulphur decision was preceded by the decision of the SEC in *Matter of Cady, Roberts and Co.*, 40 S.E.C. 907 (1961). In that case the SEC indicated clearly that a violation of Rule 10b-5 could arise from non-disclosure of material facts, in other than a face-to-face transaction.

> of such information knowing it is unavailable to those with whom he is dealing," i.e. the investing public. . . .
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> • • •
>
> Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such information remains undisclosed.

SEC v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848. *SEC* v. *Texas Gulf Sulphur, supra,* involved an SEC enforcement action against the company and several corporate investers. That particular case did not involve an attempt to impose civil liability for damages upon insiders who trade in the open market without disclosure of inside information.

An early effort to impose civil liability in the context of non-disclosure of inside information is found in *Joseph* v. *Farnsworth Radio and Television Corp.*, 99 F. Supp. 701 (S.D. N.Y. 1951) *aff'd.* 198 F.2d 883 (2d Cir. 1952), where District Judge Sugarman framed the issue thus:

> The issue is narrowed to merely this: May A, who purchased stock of the F Corporation on November 12th and B, who likewise purchased stock of the same corporation on December 13th, each on a national stock exchange and each at a price higher than he would have paid therefor had he known the true financial condition of F, recover from C, D and E, the directors and officers of the corporation, the difference between that paid and that which would have been paid had C, D and E disclosed, between the previous March 19th and October 30th when they were unloading their own stock in F, that F was in a straitened financial condition?

99 F. Supp. 701, 706. In granting a defense motion to dis-

miss for failure to state a claim upon which relief could be granted, Judge Sugarman observed:

> Nothing in the history of the Act or the Rule permits the far-reaching effect sought herein by the plaintiffs. A semblance of privity between the vendor and purchaser of the security in connection with which the improper act, practice or course of business was invoked seems to be requisite and it is entirely lacking here.

99 F. Supp. at 706.[21]

A similar result was reached, but for different reasons, in *Reynolds* v. *Texas Gulf Sulphur Co.*, 309 F. Supp. 548 (D. Utah 1970), *aff'd. as modified*, 446 F.2d 90 (10th Cir. 1971), *cert. denied*, 404 U.S. 1004, 405 U.S. 918 (1972), a private 10b-5 action arising out of the same transactions challenged

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[21] The Second Circuit affirmed the district court judgment in *Farnsworth* on a divided vote. The majority felt the judgment could be affirmed on the basis of the district judge's opinion and upon the decision in *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461 (2d Cir. 1952). We have seriously considered but have declined to place final reliance upon any claim of lack of standing within the meaning of *Birnbaum*, *supra*, or *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975). While plaintiffs were all sellers of stock in Old Line during the period of non-disclosure, none of them sold directly or indirectly to the defendants. Thus it could be argued the plaintiffs here did not possess standing to sue under § 10(b) because the wrongful activity of defendants was not "in connection with" plaintiffs' sales. While the facts here are distinguishable from those in *Birnbaum* and *Blue Chip*, we recognize that this may not end the standing issue, even then. *Birnbaum* excludes certain classes of investors; it does not confer standing on all other classes of investors. We agree with Justice Douglas that "Generalizations about standing to sue are largely worthless as such", *Data Processing Service* v. *Camp*, 397 U.S. 150, 151 (1969), and with Judge Tamm that standing to sue is "one of the most amorphous concepts in the entire domain of the public law." *Scanwell Laboratories, Inc.* v. *Shaffer*, 424 F. 2d 859, 861 (D.C. Cir. 1970). In one sense, our finding here that defendants' wrong caused no damage to plaintiffs amounts to a finding that that challenged action has not caused these plaintiffs "injury in fact, economic or otherwise", an essential element of standing within the meaning of *Data Processing Service* v. *Camp*, *supra*, 397 U.S. 150, 152. Again, in the sense that standing looks to the status of plaintiffs as a class of suitors, it is certainly true that our decision here, which in effect refuses to expand broadly the class of plaintiffs who may sue under Rule 10b-5, is intended to avoid many of the same dangers foreseen by Justice Rehnquist in *Blue Chip Stamps*, *supra*, 421 U.S. 723, 738-748.

by the SEC in *SEC* v. *Texas Gulf Sulphur Co.*, *supra*. There one of the plaintiffs, Lawrence A. Karlson, sought damages for profits he claimed to have lost when he sold his TGS stock on December 11, 1963. It was established, in particular, that the defendant Fogarty, a vice-president of TGS, had purchased TGS stock prior to and after Karlson had sold his shares without publicly disclosing the inside information he possessed. Both Karlson and Fogarty had traded through a national stock exchange. The district judge noted that there was no face-to-face transaction and that Fogarty did not purchase the particular shares sold by Karlson. In denying recovery to Karlson, the district judge noted that while it was not necessary that he establish privity of contract in order to recover, it was nevertheless necessary for Karlson to prove "some causative effect":

> In the case brought against Texas Gulf Sulphur Company, Fogarty and other TGS officials and employees, by the Securities and Exchange Commission,[17] the Circuit Court found that Fogarty had violated Section 10(b) and Rule 10b-5 by purchasing TGS stock without publicly disclosing the insider information he possessed. It does not follow that such purchases by Fogarty, some of which were made prior to the time Karlson sold his stock, caused any damage to Karlson, and the record before us does not support any such contention.

309 F. Supp. 548, 558 (Footnote omitted).[22]

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[22] Karlson did not appeal the district court judgment denying him relief; therefore, the causation issue was not presented to the Tenth Circuit. One other court has in dictum addressed the problem presented here and concluded that plaintiffs trading on an impersonal market would have no cause of action under Rule 10b-5 because of the lack of any causal connection between the injury to plaintiffs and defendants' misconduct. In *Financial Industrial Fund, Inc.* v. *McDonnell Douglas Corp.*, 315 F. Supp. 42 (D. Colo. 1970) *rev'd. on other grounds*, 474 F. 2d 514 (10th Cir. 1973), Judge William E. Doyle stated:

> Turning to plaintiff's second theory, the theory of tipping and insider trading, defendants contend that as a matter of law no claim for relief exists under the facts alleged by plaintiff. It is doubtful that tipping which results in insider trading on a

A different result has been indicated in *Shapiro* v. *Merrill Lynch, Pierce, Fenner and Smith, Inc.*, 353 F. Supp. 264 (S.D. N.Y. 1973) *aff'd.* 495 F.2d 228 (2d Cir. 1974). In *Shapiro, supra,* plaintiffs were purchasers of common stock of Douglas Aircraft Corporation during the period of June 20-24, 1966 on the New York Stock Exchange. On June 24, 1966, public disclosure was made by Douglas of a drastic change in its financial situation which had occurred since June 7, 1966, the date of the release of its earnings report for the first five months of 1966. That report indicated a favorable earnings picture. Between June 16 and June 20 the management of Douglas learned that, contrary to the June 7 release, Douglas would be reporting substantially lower earnings for the first six months of fiscal 1966 and that there would be little or no profit for the company during that year, with substantially reduced earnings for fiscal 1967. Defendant Merrill Lynch was engaged by Douglas as a managing underwriter for a proposed offering by Douglas of $75,000,000 in convertible debentures. Presumably because of this relationship, the information of the changed earnings picture was promptly transmitted to Merrill Lynch but without public disclosure. Plaintiffs alleged that thereafter, between June 20 and June 24, 1966, Merrill Lynch and certain of its directors and employees divulged this inside information to certain of their institutional investors who, in turn, sold their Douglas common stock on the New York Stock Exchange without disclosing the inside information to the public.

In an extensive and carefully drafted opinion, District Judge Charles H. Tenney denied a defense motion for judgment on

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national exchange can support a private action for damages under 10b-5. Where a corporation withholds material information from the public, a certain number of persons trading on the basis of insufficient information will be injured. This injury is not increased if corporate insiders who possess inside information are trading on the exchange at the same time. It is the incomplete information, not insider trading, which is the proximate cause of the damage to other investors.

315 F. Supp. 42, 44.

the pleadings, holding that if the allegations were proved, they would amount to violations of Section 10(b) and Rule 10b-5 and render the defendants liable to the plaintiffs who, during the period of June 20-24, purchased Douglas stock in the open market without knowledge of the earnings information which was in the possession of the defendants.

In *Shapiro*, plaintiffs did not allege that they had actually traded with the defendants. Neither does it appear from the opinion that defendants' act of trading had any influence upon their own decision to purchase. In their motion to dismiss, defendants contended that their violation of Rule 10b-5, even if proved, did not cause any damage to plaintiffs and that since plaintiffs would have bought the stock in any event, no injury to plaintiffs was occasioned. Judge Tenney rejected this analysis:

> But therein lies the fallacy of defendants' reasoning: it is not the act of trading which causes plaintiffs' injury, *it is the act of trading without disclosing material inside information which causes plaintiffs' injury.* Had Merrill Lynch and the individual defendants refrained from divulging the earnings information to the selling defendants, or had the selling defendants decided not to trade, there would have been no liability for plaintiffs' injury due to the eventual public disclosure of Douglas' poor financial position. But defendants did not choose to follow that course of action, and by trading in Douglas stock on a national securities exchange they assumed the duty to disclose the information to all potential buyers. It is the breach of this duty which gives rise to defendants' liability.

353 F. Supp. 264, 278.

The Second Circuit, in affirming the district court judgment, agreed with Judge Tenney's analysis and further concluded that any argument defendants might make that their conduct did not cause plaintiffs' damage was precluded by the Supreme

Court holding in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972):

> The short, and we believe conclusive, answer to defendants' assertion that their conduct did not "cause" damage to plaintiffs is the "causation in fact" holding by the Supreme Court in Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972), upon the authority of which we conclude that the requisite element of causation in fact has been established here by the uncontroverted facts that defendants traded in or recommended trading in Douglas stock without disclosing material inside information which plaintiffs as reasonable investors might have considered important in making their decision to purchase Douglas stock.

495 F.2d 228, 238. While neither court endeavored to rule upon the measure of any damages which might ultimately be allowed, the Second Circuit observed:

> Moreover, we do not foreclose the possibility that an analysis by the district court of the nature and character of the Rule 10b-5 violations committed may require limiting the extent of liability imposed on either class of defendants.

Shapiro v. *Merrill Lynch, supra*, 495 F.2d 228, 242.

Thus it appears that both the district court and the Second Circuit in their respective opinions in *Shapiro, supra*, were ready and willing to extend the 10b-5 private right of action to accord relief to those who traded upon an impersonal market where the defendants were charged with violation of the "abstain or disclose" rule in *SEC* v. *Texas Gulf Sulphur, supra*.

As the foregoing cases illustrate, extension of the private civil remedy under Rule 10b-5 where shares have been traded upon an impersonal market has eluded uniform analysis by judicial writers. The courts and legal writers seem to agree that the plaintiff must establish a causal connection between

the defendant's misconduct and his loss, *Bromberg, supra*, § 8.7.1 at 213-14, but what exactly plaintiff must show to establish this causal element is unclear.

IV.

We conclude that upon the facts of this case defendants' conduct caused no injury to plaintiffs and the judgment of the district court must be reversed. It is undisputed that defendants did not purchase any shares of stock from plaintiffs, and that defendants' acts of trading in no way affected plaintiffs' decision to sell.

We are unable to agree with the observation of the district judge in *Shapiro* that ". . . it is the act of trading without disclosing material inside information which causes plaintiffs' injury . . . Having breached that obligation [to abstain or disclose], the defendants are liable for plaintiffs' injuries." 353 F. Supp. 264, 278. The flaw in this logic, we conclude, is that it assumes the very injury which it then declares compensable. It does so by presupposing that the duty to disclose is absolute, and that the plaintiff is injured when the information is denied him. The duty to disclose, however, is not an absolute one, but an alternative one, that of either disclosing or abstaining from trading.[23] We conceive it to be the act of

[23] In *Shapiro*, Judge Tenney attempted to analogize the alternative nature of an insider's duty under the abstain or disclose rule to the duty of a person helping a drowning man. Under tort law, there is no duty imposed upon an individual to save a drowning man. If, however, defendant gets in a boat and extends his hand to save the man and thereafter lets go, the law will hold him liable for the drowning man's death. Judge Tenney argued that when defendants decided to trade, this created a further duty to disclose, the breach of which caused plaintiff's injury.

We find the analogy unpersuasive. It is quite clear that in the above situation, the defendant's decision to let go of the drowning man's hand is the cause of his death. Here, defendants' intervening act, the act of trading with a third person, bears absolutely no causal relationship whatsoever to plaintiffs' injury. The faceless nature of the securities market makes plaintiffs' loss totally unrelated to defendants' breach of Rule 10b-5 which occurs when defendant trades.

trading which essentially constitutes the violation of Rule 10b-5, for it is this which brings the illicit benefit to the insider, and it is this conduct which impairs the integrity of the market and which is the target of the rule. If the insider does not trade, he has an absolute right to keep material information secret. *SEC* v. *Texas Gulf Sulphur Co., supra,* at 848. Investors must be prepared to accept the risk of trading in an open market without complete or always accurate information. Defendants' trading did not alter plaintiffs' expectations when they sold their stock, and in no way influenced plaintiffs' trading decision. *See* Ratner, *Federal and State Roles in the Regulation of Insider Trading*, 31 Bus. Law 947, 966-67 (remarks of Robert Mundheim).

We hold, therefore, the defendants' act of trading with third persons was not causally connected with any claimed loss by plaintiffs who traded on the impersonal market and who were otherwise unaffected by the wrongful acts of the insider.[24]

Likewise, we are not persuaded, as was the Second Circuit in its decision in *Shapiro, supra,* that *Affiliated Ute Citizens* v. *United States, supra,* mandates a "short, and . . . conclusive answer" to the contrary, 495 F.2d 228, 238.

In *Affiliated Ute,* certain members of the Ute Indian tribe brought suit against a bank and two of its employees under Rule 10b-5. The basis of the complaint was that the bank, which held certain shares of stock owned by plaintiffs, had

[24] The question of causation of injury when insiders trade in the open market has generated considerable comment. *See e.g.,* Bromberg, *supra,* §§ 7.4, 8.7, Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5,* 65 Colum.L.Rev. 1361, 1372, 1377-78 (1965), Painter, Federal Regulation of Insider Trading, 125 (1968), Ratner, *Federal and State Roles in the Regulation of Insider Trading,* 31 Bus. Law 947, 955-56 (1976), Comment, *Damages to Uninformed Traders for Insider Trading on Impersonal Exchanges,* 74 Colum.L.Rev. 299, 314-15, 319 (1974), Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code,* 72 Mich. L. Rev. 1398, 1423-24, 1429 (1974), Comment, *Insiders' Liability Under Rule 10b-5 for the Illegal Purchase of Actively Traded Securities,* 78 Yale L.J. 864, 870-872 (1969), Note, 80 Harv. L. Rev. 468, 475 (1966), Note, *Civil Liability Under Section 10(b) and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity,* 74 Yale L.J. 658, 675-76 (1965).

arranged sales of the stock without disclosing to the plaintiffs certain material information, including the fact that defendants were making a market in the stock, purchasing some of it for their own account, and that the stock was sold for a substantially higher price to non-members of the tribe. The district judge entered judgment for plaintiffs. The Court of Appeals reversed, holding there could be no recovery under § 10(b) and Rule 10b-5 without proof that the plaintiffs had relied upon some misrepresentation by defendants. In reversing the Court of Appeals, the Supreme Court held:

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. See *Mills* v. *Electric Auto-Lite Co.,* 396 U.S. 375, 384 (1970); *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 849 (CA2 1968), cert. denied *sub nom. Coates* v. *SEC,* 394 U.S. 976 (1969); 6 L. Loss, Securities Regulation 3876-880 (1969 Supp. to 2d ed. of Vol. 3); A. Bromberg, Securities Law, Fraud—SEC Rule 10b-5, §§ 2.6 and 8.6 (1967). This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact. *Chasins* v. *Smith, Barney & Co.,* 438 F.2d, at 1172.

406 U.S. 128, 153-54.

It is this language which the Second Circuit, in *Shapiro,* felt to be controlling upon it. We are unable to construe the language quoted so broadly. It was shown in *Affiliated Ute* that the defendant bank employees had engaged in prior business dealings with the plaintiff Indians.[25] They entered

[25] It seems clear that because of their prior business dealings with plaintiffs, defendants in *Affiliated Ute* owed a duty of disclosure to them. For en extensive discussion of the case, *see* Comment, *Affiliated Ute Citizens* v. *United States — The Supreme Court Speaks on Rule 10b-5,* 1973 Utah L. Rev. 119.

into a deliberate scheme to induce the plaintiffs to sell their stock without disclosure of material facts which would have influenced the decision to sell. The resulting sales were a direct result of the scheme. Thus it comes as no surprise that the Supreme Court concluded that "[U]nder the circumstances of this case," 406 U.S. 128, 153, all that was necessary was that the information withheld be material in order to establish the requisite causation.

That the quoted language was not intended to produce such a far-reaching result we think is indicated by Justice Blackmun's reference therein to *Chasins* v. *Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970). *Chasins*, like *Affiliated Ute*, involved direct dealings between Chasins, an investor, and Smith, Barney & Co. as his broker-dealer. It was charged that Smith, Barney & Co., in handling Chasins' accounts, had violated Rule 10b-5 by failing to disclose when it strongly recommended certain stocks to Chasins that it was also a market maker in those same stocks. The question immediately before the court was whether, as part of his proofs, Chasins must show that in making his purchases he in fact relied upon the recommendation made. Under the facts of the case, the court concluded that positive proof of reliance was not required:

> To the extent that reliance is necessary for a finding of a 10b-5 violation in a non-disclosure case such as this, the test is properly one of tort "causation in fact." Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969). Chasins relied upon Smith, Barney's recommendations of purchase made without the disclosure of a material fact, purchased the securities recommended, and suffered a loss in their resale. Causation in fact or adequate reliance was sufficiently shown by Chasins.

438 F.2d 1167, 1172.

Here, unlike *Affiliated Ute*, defendants did not perpetrate any scheme to induce defendants to sell their stock. Plaintiffs

and defendants here had no relationship whatever during the period in question. The plaintiffs in *Affiliated Ute* had a right to expect that the defendant bank officials would fully disclose all material information concerning the stock while inducing them to sell. When defendants did not make full disclosure, they breached Rule 10b-5 and became liable for plaintiffs' foreseeable damages. The type of relationship existing between plaintiffs and defendants in *Affiliated Ute* is totally absent here.

V.

Neither do we believe that sound policy considerations support the result reached by the district court.[26] Logic, at first blush, tends to support extension of the civil remedy to persons trading in an impersonal market in the context presented here. Congress certainly never intended § 10(b) to be limited in its scope solely to face-to-face transactions. Indeed since the Securities Exchange Act of 1934 is aimed at nationwide practices, H. R. No. 1383, 73rd Cong., 2nd Sess. 11 (1934), it would be idle to exclude from its operation those over-the-counter and national stock exchange transactions which are most characteristic of the national market. *See SEC* v. *Texas Gulf Sulphur, supra*, 401 F.2d 833, 848.

The key issue, as we see it, is not whether the proscriptions of § 10(b) and Rule 10b-5 should encompass open market transactions, which they should, but whether the civil remedy

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[26] We think it appropriate that the court take into account policy considerations in deciding questions concerning the scope of civil actions under Rule 10b-5. As noted by Justice Rehnquist in *Blue Chip Stamps, supra*:

> . . . it would be disingenuous to suggest that Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5. It is therefore proper that we consider . . . what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.

421 U.S. 723, 737.

must invariably be coextensive in its reach with the reach of the SEC, which under the Act, was designated by the Congress as the primary vehicle of its enforcement. We reject such a view where its application leads us inexorably to an unjust and unworkable result.[27] By so extending the liability of defendants here beyond that which has already been imposed through the SEC enforcement action, we believe we would be doing violence to the intent of the statute and rule, creating a windfall for those fortuitous enough to be aware of their nebulous legal rights, and imposing what essentially must be considered punitive damages almost unlimited in their potential scope.[28]

Where private civil actions under Rule 10b-5 have been employed in essentially face-to-face situations, the potential breadth of the action was usually contained. However, extension of the private remedy to impersonal market cases where plaintiffs have neither dealt with defendants nor been influenced in their trading decisions by any act of the defendants would present a situation wholly lacking in the natural limitations on damages present in cases dealing with face-to-face transactions. We think the potential liability of Bradford, Jr. in this case, noted earlier, is sufficiently illustrative of the dangers posed.[29]

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[27] We specifically do not reach the question of availability of the remedy to open market situations where the insider trading with resultant price changes has in fact induced the plaintiffs to buy or sell to their injury. *See* Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 Colum.L.Rev. 1361, 1370 (1965). Here there was no proof that defendants' insider trading had any impact whatever upon the value of Old Line stock.

[28] We express concern similar to that noted by Judge Friendly in his concurring opinion in *SEC* v. *Texas Gulf Sulphur, supra,* that broad extension of the civil remedy under Rule 10b-5 in open market cases "will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers . . ." 401 F. 2d 833, 837. *See also Blue Chip Stamps, supra,* 421 U.S. 723, 739.

[29] Plaintiffs sold Old Line stock in the over-the-counter market in various lots on June 13, 14 and 15, 1972. Based upon the market data received in evidence at the trial, if all of the persons who had sold their shares of Old Line stock on those days alone had joined

We recognize that in precluding recovery here, it may be argued that the deterrent impact on insider trading of a large award of damages is thereby lost. A similar argument was found unpersuasive by the Supreme Court in *Bangor Punta Operations* v. *Bangor & A.R. Co.*, 417 U.S. 703 (1974). In that case, Bangor Punta Corporation sold all of its stock (98%) in a subsidiary company to Aroostook Corporation, which then assumed responsibility for the subsidiary's management and acquired additional shares to give it 99% ownership of the subsidiary. Suit was then brought by the subsidiary against Bangor Punta, alleging various acts of mismanagement during a seven year period prior to Bangor Punta's sale of the subsidiary. The Supreme Court upheld the district court dismissal of the action holding that Aroostook Corporation, the beneficiary of any recovery, was not injured by any mismanagement of the subsidiary which may have occurred.

Noting an assertion by the Court of Appeals that allowing recovery would assure that the Bangor Punta would not be immune from liability for its wrongful conduct and would serve a public purpose by providing a needed deterrent to corporate mismanagement, Justice Powell observed:

> Our difficulty with this argument is that it proves too much. If deterrence were the only objective, then in logic any plaintiff willing to file a complaint would suffice. No injury or violation of a legal duty to the particular plaintiff would have to be alleged. The only prerequisite would be that the plaintiff agree to accept the recovery, lest the supposed wrongdoer be allowed to escape a

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in the instant lawsuit, Bradford Jr.'s potential liability in damages would have totalled approximately $800,000. If a class action had been brought which included all investors who sold Old Line stock between April 21 and June 29, 1972, the damages could have totalled approximately $3,700,000. If the class had been further expanded to those selling up to November 20, 1972 (and the holding appealed from admits of no limitation short thereof), the damages would have run in excess of $7,000,000.00. As noted earlier, Bradford, Jr.'s profit from his illegal purchases, already disgorged in an SEC proceeding, amounted to about $13,000.

reckoning. Suffice it to say that we have been referred to no authority which would support so novel a result, and we decline to adopt it.

417 U.S. 703, 717.

While we hold to the view that the private action should be compensatory, it is to be observed that in any event the 1934 Act provides a number of non-compensatory sanctions to deter insider misconduct, including SEC investigations and criminal sanctions.[30] Further, the SEC may ask the federal district court, in the exercise of its equity jurisdiction under § 27 of the 1934 Act, to require an insider to disgorge any profits he may have made from his illegal trading, *SEC* v. *Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir. 1971), *cert. denied*, 404 U.S. 1005 (1971), or even an amount in excess of the amount of illicit profits which the insider has made. *SEC* v. *Shapiro*, 494 F.2d 1301, 1309 (2d Cir. 1974).[31] Finally, state law may provide various sanctions against insider trading.[32]

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30 The SEC, as the agency designated by Congress to enforce the securities laws, has express power to conduct investigations of past or potential violations of those laws. 15 U.S.C. § 78u(a)-(c). It may turn over information gathered through investigations to the attorney general for use in criminal prosecutions. 15 U.S.C. § 78u(e). The 1934 Act provides for fines and imprisonment of up to five years for willful violations of the Act. 15 U.S.C. § 78ff (as amended June 4, 1975).

31 Such relief has been held available where the SEC seeks the disgorging of profits as "ancillary" relief to an injunction against future violations of the Act. 15 U.S.C. § 78u(e). There may be situations, however, where the SEC will prefer to bring an administrative proceeding rather than go into court seeking injunctive relief. One such case was *Investors Management Co., Inc.*, SEC Sec. Ex. Rel. No. 9267 (July 29, 1971), an administrative action involving the same facts out of which the litigation in *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith* arose. In such situations, however, the SEC itself has no power to require the respondents in its proceeding to disgorge profits. *See* Ratner, *Federal and State Roles in the Regulation of Insider Trading*, 31 Bus. Law, 947, 954 (1976).

32 Most state courts appear not to recognize any cause of action by an individual where an insider has traded in the open market on inside information. *Goodwin* v. *Agassiz*, 283 Mass. 358, 186 N.E. 659 (1933). However, some states have recognized that the insider may be held liable to the corporation for the profit made on his improper trading. *Brophy* v. *Cities Service Co.*, 31 Del. Ch. 241, 70 A. 2d 5 (1949). One court has indicated that sanctioning such suits is necessary as a deterrent against insider trading by corporate officers. *Diamond* v. *Oreamuno*, 24 N.Y. 2d 494, 248 N.E. 2d 910, 301 N.Y.S. 2d 78 (1969).

Whether the sanctions imposed upon the defendants here together with others which were also available amount to a sufficient vindication of the public rights and to an adequate deterrent to future misconduct we need not say. We may at least observe that the impact is bound to be significant.

Finally, it has been suggested that the problem of unlimited damages can be avoided by allowing recovery to all plaintiffs who traded during the period of non-disclosure, but limiting recovery to the amount of defendants' profits from insider trading. This type of limitation has been incorporated into the proposed ALI Federal Securities Code (Tent. Draft No. 2, March 1973). In situations where the insider trades in an impersonal market on inside information, § 1402(f)(2)(B) of the proposed Code limits the damages for which he becomes liable "to the extent of the securities that the defendant sold or bought". Thus were the proposed Code in effect in this case, defendants' liability would presumably be limited to the amount by which the price of Old Line stock increased between the time they purchased and the time of public disclosure of the inside information multiplied by the number of shares defendant purchased. *See* Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code*, 72 Mich. L. Rev. 1398, 1428 (1974).

As compared to Congress or administrative agencies such as the SEC, we think the courts are ill-fitted to the task of rule-making which would be required. As we see no connection between defendants' violation of Rule 10b-5 and plaintiffs' alleged losses, we decline to base our decision upon a rule of limitation of damages here.[33]

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33 It seems clear that if recovery is to be allowed against insiders in an open market context, some limitations upon damages must

The district judge alternatively found that defendants Bradford, Bradford, Jr. and Bradford and Co. had violated Rule 10b-6 by trading in Old Line stock as broker-dealers during the period that negotiations of the merger were occurring. As noted earlier, none of these defendants ever traded with plaintiffs, nor is there any proof their trading activities caused any change in the price of Old Line stock or in any way influenced plaintiffs' decision to sell. Accordingly, our conclusion that defendants' conduct in no way caused any loss to plaintiffs is equally applicable to a theory of liability under Rule 10b-6.

Reversed and remanded for entry of judgment for defendants.

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be imposed. Imposition of unlimited liability could not only lead to individual injustice, but would have the effect of leading corporate officers, directors and other insiders to refrain from trading in the corporation with which they are associated. We cannot believe that this unhealthy result was intended by Congress in enacting the 1934 Act.

Judge CELEBREZZE concurring:

I concur in the result reached by the Court. However, because of the importance of defining the scope of civil liability under rule 10b-5 in an open market context and the apparent divergence of today's decision and that of the Second Circuit in *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974), *aff'g* 353 F.Supp. 264 (S.D.N.Y. 1972), I feel compelled to explain my reasons for joining in the Court's decision.

There is no doubt that Appellants, J. C. Bradford and J. C. Bradford, Jr., actively engaged in trading for their own account on the basis of material inside information which had not been disclosed to the trading public. This was a patent violation of the "disclose or abstain" rule announced in *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2nd Cir. 1968). In *Shapiro* the Second Circuit extended the rule to provide a basis for recovery in private actions for damages. 495 F.2d at 236. I do not read today's decision as a repudiation of the "disclose or abstain" rule in private damage actions. Rather, I see the Court's opinion as imposing a rational limitation on the scope of civil liability under rule 10b-5 for insiders trading in the open market.

There is an obvious need to restrict the scope of civil liability of insiders trading in the open market. If an insider trades in a widely-held stock which is actively traded on a national market, the number of potential plaintiffs could be astronomical and the possible award of damages may be grossly disproportionate to the volume of the insider trading. The Supreme Court in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 745-47 (1975), recently addressed the problem of limiting the class of potential plaintiffs in 10b-5 civil actions. The majority, in affirming the purchaser-seller requirement of *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1951), expressed alarm at the potentially vast number of persons who could conceivably bring civil suits under rule 10b-5

absent meaningful restrictions on the scope of the judicially-created cause of action. The Supreme Court exhorted federal courts to consider the practical implications of extending civil remedies to those who bear only a tangential relationship to the transactions giving rise to violations of rule 10b-5. 421 U.S. at 749.

The limitations this Court places on the scope of an insider's liability in damages to traders on the open market is consistent with the directive of *Blue Chip Stamps*. An insider who breaches the "disclose or abstain" rule by trading in the open market should not become a virtual insurer for losses sustained by those who happen to trade in the same stock weeks after the insider has ceased his trading activities.[1] There must be some causative link between breach of the insider's duty to disclose the withheld information before trading and the losses incurred by would-be plaintiffs.[2] On the other hand, an insider should not escape civil liability for conduct which would clearly violate rule 10b-5 in a face-to-face transaction, by the simple expedient of restricting his trading to the open market where the mechanics of the marketplace make it difficult, if not impossible, to trace particular transactions.[3]

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[1] [T]he aim of the rule [10b-5] in cases such as this is to qualify, as between insiders and outsiders, the doctrine of *caveat emptor* — not to establish a scheme of investors' insurance.

List v. *Fashion Park, Inc.*, 340 F. 2d 457, 463 (2d Cir. 1965).

[2] Causation, as an element of 10b-5, must be proved in some form or "else defendants could be held liable to all the world." *Globus* v. *Law Research Service, Inc.*, 418 F.2d 1276, 1292 (2d Cir. 1969).

[3] The mechanics of trading in the over-the-counter market are detailed in the Court's opinion. Transactions are negotiated through broker-dealers who match buy and sell orders at random. Traders in the market have no way of identifying the ultimate sellers or purchasers of shares traded. No matter how an insider trade is accomplished, however, there are certain to be investors on the opposite side of the transaction who are deserving of rule 10b-5 protection. It would be anomalous if the impersonal nature of trading on the open market was to defeat civil liability for insiders trading in violation of rule 10b-5 since the trading markets were the original targets of Congress in 1934. *See* A. Bromberg, Securities Law: Fraud — SEC Rule 10b-5 § 817(1) at 217 (1971).

It was fear of creating a loophole in the "disclose or abstain" rule which led the Second Circuit in *Shapiro* to reject the argument that the rule should be restricted to SEC injunctive actions or to private suits where the actual purchasers of the stock could be identified. 495 F.2d at 236-37. To do so, the Court reasoned, would be to circumvent the strong policy considerations supporting the rule and "make a mockery" of an insider's duty to disclose or abstain from trading.[4] *Id.* Indeed, the "disclose or abstain" rule was devised to cope with the difficulty in tracing transactions in an impersonal market. Since the mechanics of the marketplace make it virtually impossible to identify the actual investors with whom an insider is trading, the duty of disclosure is owed to investors as a class who trade on the market during the period of insider trading.[5] As the Court stated in *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d at 848:

> [T]he Rule is based in policy on the justifiable expectations of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information . . . .

The essence of the "disclose or abstain" rule is the inherent unfairness in allowing an insider to enter the open market and

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[4] In this case the defendants purchased the bulk of their shares from the inventory of their own brokerage house, J. C. Bradford & Co. They were, in effect, trading with themselves. If recovery were limited to those who actually sold Old Line stock to defendants, their own company would be the principal plaintiff. This would be an absurdity. An insider should not be immunized from liability simply because he trades through intermediaries. *See Strong* v. *Repide*, 213 U.S. 419 (1909). The real persons requiring protection are the anonymous investors whose Old Line shares were funneled to defendants through various broker-dealers.

[5] Since in any active market disclosure to a particular individual is not feasible, the duty to disclose, if such a duty exists, must be owed to all members of that ill-defined class of stockholders who, with the benefit of inside information, would alter their intention to sell. Thus, it must be concluded that all those who sold while the defendant was purchasing should be accorded equal rights of recovery.

Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law*, 65 Colum. L. Rev. 1361, 1378 (1965).

trade for his own account in the securities of a corporation on the basis of material inside information "'knowing [such information] is unavailable to those with whom he is dealing,' i.e., the investing public." *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d at 848, *quoting Matter of Cady, Roberts & Co.*, 40 SEC 907, 912 (1961). "It is, in fact, the insider's advantage over others in trading the corporation's securities which gives rise to the duty of disclosure." Painter, 65 COLUM. L. REV. at 1384. The "disclose or abstain" rule accomplishes two salutory purposes of rule 10b-5: it insures the integrity of the marketplace and it compensates for the inequity of trading with a corporate insider who has superior access to material inside information.[6] *See* 401 F.2d at 848.

Given the availability of the "disclose or abstain" rule to private litigants, the problem of identifying those entitled to recover for breach of that duty remains. At common law,

[6] One commentator has suggested that compensatory remedies are inappropriate where trading in the open market is concerned. Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code*, 72 *Mich. L. Rev.* 1398, 1492 (1974). He states that deterrence should be the goal of 10b-5 in the open market and that curbing an insider's "abuse of the market" is better left to SEC investigations and criminal sanctions. One problem with the author's suggestion is that SEC manpower is limited and the time necessary to investigate and prosecute cases which now are processed through the civil courts would, in many cases, be prohibitive. Another is the limitation on the scope of remedies available to the SEC. Although courts have ordered disgorgement of profits as "ancillary relief" in SEC injunctive actions, there is no such remedy if the Commission chooses to proceed through administrative actions against investment advisors or broker-dealers. *See Ratner, Federal and State Roles in the Regulation of Insider Trading*, 31 BUS. LAW. 947, 954-55 (Feb. 1976). Also, merely requiring an insider to disgorge the profits he made through his illegal trading may not satisfy either the deterrent or compensatory goals of rule 10b-5. Criminal sanctions are an inadequate substitute for civil proceedings because of the different standard of proof and other factors unrelated to securities regulation which make a conviction for criminal charges much more difficult to procure than a finding of civil liability. Civil liability serves both the deterrent and the compensatory functions of rule 10b-5. The prospect of a substantial money judgment is likely to cause an insider to pause and reflect before entering the market to trade on the basis of confidential information and, at the same time, bolster the confidence of investors that they need not accept the financial "risk" of trading with individuals who have superior access to inside information.

recovery for deceit was limited to these who could show "reliance" and "privity". *See generally* W. PROSSER, LAW OF TORTS § 105 at 685-86, 700-02 (4th ed. 1971). Due to the impersonal nature of trading on the open market and the remedial purpose of rule 10b-5, "privity" and "reliance" as means for limiting the plaintiff class have generally fallen into disfavor. *See generally* Painter at 1370, 1372. Since there is no practical method for matching purchases and sales in the open market, requiring privity in the common law sense as an element of rule 10b-5 would create an insurmountable obstacle for plaintiffs.[7] Reliance also has little relevance to trading in the open market where there are no face-to-face negotiations as a rule, and where non-disclosure of a material fact is often the gravamen of the complaint. *See* e.g., *Blackie* v. *Barrack*, 524 F.2d 891, 905-06 (9th Cir. 1975). *See also* Note, *The Reliance Requirement In Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 589-600 (1975).

Without reliance, however, there is no causative link between defendants' conduct and plaintiffs' investment decisions. And without at least a "semblance of privity" defendants' liability could extend to complete strangers. *See Joseph* v. *Farnsworth Radio and Television Corp.*, 99 F. Supp. 701, 706 (S.D.N.Y. 1951), *aff'd* 198 F.2d 883 (2d Cir. 1952). *Cf. Globus* v. *Law Research Service, Inc.*, 418 F.2d 1276, 1292 (2d Cir. 1969). In *Affiliated Ute Citizens* v. *United States*, 496 U.S. 128, 153-54 (1972), the Supreme Court dispensed with the requirement of showing actual reliance where liability was grounded on the non-disclosure of a material fact

[7] Plaintiffs should not be required to prove that it was their particular stock certificates which passed through various brokerage houses and came to rest in an insider's portfolio. As the Second Circuit said in *Shapiro*, 495 F.2d at 239: "It would make a mockery of the 'disclose or abstain' rule if we were to permit the fortuitous matching of buy and sell orders to determine whether a duty of disclosure were violated." *See also* Painter, 65 COLUM. L. REV. at 1372, 1377-78. One commentator has suggested that courts have dismissed cases for "lack of privity" when their real concern was over the absence of causation between the insider's trading and the plaintiff's losses. BROMBERG § 8.7(1) at 215 n. 68.

by individuals in a fiduciary relationship to the plaintiffs. Where there is such a relationship, the Court indicated that all that need be shown to prove causation is "causation-in-fact" — an affirmative obligation of disclosure and the withholding of material information. 406 U.S. at 153-54. Because of the materiality of the information, the Court was willing to presume that disclosure would have affected plaintiffs' investment decisions.[8] *See generally* Note, *Reliance Under Rule 10b-5*, 24 CASE W. RES. L. REV. 363, 385-88 (1973). In *Shapiro* the Second Circuit found *Affiliated Ute* controlling on the causation issue. 495 F.2d at 238. The Court reasoned that the duty of disclosure imposed on an insider who chooses to sell or recommend selling a certain stock on the basis of material inside information establishes the requisite element of causation-in-fact for those who purchased that stock during the same period. 495 F.2d at 240-41.

In the present case, the Court holds that persons who trade on an open market weeks after an insider has concluded his trading activity must establish more than the materiality of the undisclosed information to demonstrate that their losses were caused by defendants' trading.[9] As the Court notes, the "disclose or abstain" rule is stated in the alternative. Trading is the gravamen of the offense.[10] The public has no absolute

[8] The presumption of causation is rebuttable. *Chelsea Assoc.* v. *Rapanos*, 527 F.2d 1266, 1271-72 (6th Cir. 1975).

[9] Although the Court specifically does not address the question of market manipulation, if an insider's trading affects the market price to the extent of creating an artificial market in a security, subsequent investors who were induced to trade on the basis of the price change could logically establish transactional causation without reference to an insider's duty to "disclose or abstain." *See Cochran* v. *Channing*, 211 F. Supp. 239 (S.D.N.Y. 1962). *See generally* 88 HARV. L. REV. at 592-96.

[10] Trading triggers the duty to "disclose or abstain" in a straight insider trading case — a case where insiders were trading solely on their own account. *Texas Gulf Sulphur* also involved tipping and the Court held that recommending a trade based on material undisclosed information also gives rise to a duty to disclose. 401 F.2d at 848. The distinction between pure insider trading and tipping has relevance to the breadth of the duty of disclosure owed investors in the market. *See* discussion *infra* at 39.

right to the undisclosed information. It is only when the insider enters the market and creates an informational imbalance that a duty to disclose is imposed to protect the anonymous investors trading with the insider. *See SEC* v. *Texas Gulf Sulphur Co., supra* at 848. The duty of disclosure is owed to the class of investors trading contemporaneously with the insider and it is only this group who are the proper beneficiaries of the relaxed causation standard of *Affiliated Ute*. These investors as a class are disadvantaged by the superior knowledge of the insider. The stocks they traded generate the insider's profits.[11]

There was admittedly no connection between Appellants' trading and Appellees' decision to sell their Old Line stock. Appellees are in precisely the same situation they would have been in if Appellants had chosen to abstain from trading. Since they entered the market weeks after Appellants had ceased trading, none of the shares they sold could possibly have been purchased by Appellants. When Appellees entered the market, the information available to investors had returned to equilibrium. Non-contemporaneous traders do not require the special protection of the "disclose or abstain" rule because they do not suffer the disadvantage of trading with someone who has superior access to information. Parties on both sides

[11] As noted above, the mechanics of the market necessitate designation of the class of contemporaneous investors as surrogate plaintiffs for those who actually traded with the insiders. This class must include investors who were in no way involved in the insider transactions, and except for the time of their trading, are indiscernable from subsequent traders. However, to accomplish the deterrent and compensatory purposes of 10b-5, it is better to be overinclusive in the definition of the plaintiff class than underinclusive.

Of course, limiting the plaintiff class to contemporaneous traders does not remove the spectre of "draconian" damages. The number of persons trading contemporaneously with an insider in the open market could still be enormous. However, one may limit liability, the prospect of a ruinous recovery remains until some realistic measure of damages is devised. But this question is better left to the remedy stage where a court can employ its equitable powers in shaping an award or until such time as the Congress chooses to act on this problem.

of the transaction have equal access to information. Of course, as a practical matter, if the insider had made full public disclosure before trading subsequent traders would have been aware of the information and able to gauge its effect on the market. In this sense, whatever losses they suffered were "caused" by the insider's failure to disclose. But, as the Court points out, that presupposes that the insider's duty of disclosure runs to investors who have no possible connection to the insider trading. I also am unwilling to extend the "disclose or abstain" rule beyond the class of investors it was designed to protect – those trading contemporaneously with the insiders.

On remand from the Second Circuit, the District Court in *Shapiro* rejected the argument that recovery should be limited to those who purchased Douglas common stock during the period when defendants were actively trading in or recommending trading in the stock. *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, CCH SEC. L. REP. ¶ 95,377 at 98,874, 98,877-78 (1976 Transfer Binder) (S.D.N.Y. Dec. 9, 1975). Instead, the District Court held that the duty of disclosure extends "to all purchasers trading contemporaneously with defendants' wrongdoing, that is, 'while such information remains undisclosed.'" *Id.* at 98,878. Under this view, Appellees would be able to recover their losses from Appellants even though there was no possible connection between their trading and that of the insiders. Recovery would simply be based on their sale of Old Line Stock sometime before effective public disclosure of the planned merger. While I agree with the District Court in *Shapiro* that "liability should be coterminous with the duty breached by the wrongdoer," *id.*, I feel that the District Court has misinterpreted the breadth of the "disclose or abstain" rule in a straight insider trading situation. To repeat, the wrong which gives rise to the duty to "disclose or abstain" is the act of trading without disclosure. Neither an insider's trading when he is not in possession of material inside information, nor the decision to abstain from trading when he does possess such information, gives rise to a duty of disclosure. That duty arises only when necessary to equalize the information available to outside investors who are actively trading with an insider who is privy to undisclosed material facts. When the insider ceases trading, the informational imbalance ends and the market returns to its normal state. However, where there is tipping in conjunction with insider trading the circumstances are significantly altered. When an insider tips material information to selected traders he is perpetuating the informational imbalance in the market and breaching a separate duty to treat all persons in the market alike. By tipping, the insider has set off a chain of events which perhaps may only be remedied by full public disclosure.[12] *Shapiro* was not a case of straight insider trading but involved tipping on a mass scale. The complaint was essentially aimed at Merrill Lynch's policy of selective leakage of information about Douglas' financial straits to favored customers who in turn unloaded their shares in the market to unwary purchasers. Under these circumstances, the District Court in *Shapiro* may have correctly defined the class of potential plaintiffs to include those in the market up to the point of effective public disclosure.

In this case, by contrast, the Bradfords engaged in a straight scheme of insider trading.[13] While I have no doubt that they knowingly violated rule 10b-5, I believe that recovery should be limited to those who sold Old Line shares between April 21st and 27th, 1972, the period when the Bradfords were ac-

[12] Tipping because it involves a more widespread imbalance of information presents an even greater threat to the integrity of the marketplace than simple insider trading. Tipping, by its very nature, is a more open-ended violation than that of the insider who enters the market, trades on his own account and withdraws.

[13] The record shows that the Bradfords purchased Old Line Stock for their own account and for accounts under their control. The District Court made no finding that they also engaged in tipping information about the merger to other investors.

tively purchasing Old Line Stock in the over-the-counter market. Since Appellees did not sell their shares during that period, I join in the Court's reversal of the decision below.

[Filed 9/15/76]

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 74-1902

JERRY D. FRIDRICH, AGNES KIM, W. BRYANT WOOSLEY, HARRY L. WOOSLEY III, and ELIZABETH M. WOOSLEY,

Plaintiffs-Appellees,

v.

J.C. BRADFORD, J.C. BRADFORD, JR., J.C. BRADFORD & COMPANY, J.C. BRADFORD AND COMPANY, INC., and LIFE STOCK RESEARCH CORPORATION,

Defendants-Appellants.

Before: CELEBREEZE, PECK and ENGEL, Circuit Judges.

JUDGMENT

APPEAL from the United States District Court for the Middle District of Tennessee.

THIS CAUSE came on to be heard on the record from the United States District Court for the Middle District of Tennessee and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby reversed and the cause remanded for entry of judgment for Defendants-Appellants.

It is further ordered that Defendants-Appellants recover from Plaintiffs-Appellees the costs on appeal, as

itemized below, and that execution therefor issue out of said District Court if necessary.

ENTERED BY ORDER OF THE COURT,

John P. Hehman, Clerk

By /s/ Grace Keller

Grace Keller, Chief Deputy
A True Copy.

Attest:

_____

Deputy Clerk

Issued as Mandate:
COSTS:

Filing fee	$
Printing	$
Total	$

MEMORANDUM

(Filed June 17, 1974)

This is a securities action against a group of individuals and companies who were members of the controlling group of stockholders of Old Line Life Insurance Company and were affiliated with J. C. Bradford & Co., a broker-dealer and market-maker effecting a high percentage of the transactions in the market of Old Line Life stock. It is a suit for violations of SEC Rules 10b-5 and 10b-6 by sellers of securities of Old Line Life who were unaware at the time of their sales of a possible merger between Old Line and USLIFE. Jurisdiction is based on Section 27 of the Securities Exchange Act, 15 U.S.C. § 78aa.

The complaint, as amended, alleges that plaintiffs sold approximately 14,000 shares of Old Line stock on June 13, 14 and 15, 1972, sales they would not have made had they known of the impending merger. Plaintiffs allege that defendants were in possession of undisclosed material inside information about the merger during the period April 19, 1972 until November 20,

1972, and that during this period defendants traded as insiders in Old Line stock for their own advantage. Plaintiffs' basic contention is that they would not have sold their stock had defendants observed legal duties requiring disclosure of inside information before trading; and as damages, plaintiffs seek the difference between the price received for their stock in the June, 1972 transactions and the highest bid price reached by the stock during the period defendants were unlawfully trading in the stock while in possession of undisclosed material inside information.

The Court finds that the defendants violated SEC Rules 10b-5 and 10b-6 and are liable to plaintiffs, as more fully set out below in the Court's Findings of Fact and Conclusions of Law. The two SEC Rules which the defendants violated are as follows:
SEC Rule 10b-5 of General Rules & Regulations under the Securities and Exchange Act of 1934:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

17 C.F.R. § 240. 10b-5 (1973).

SEC Rule 10b-6 of General Rules & Regulations under the Securities and Exchange Act of 1934:

"(a) It shall constitute a 'manipulative or deceptive device or contrivance' as used in § 10(b) of the Act for any person,

(1) who is an underwriter or prospective underwriter in a particular distribution of securities, or

(2) who is the issuer or other person on whose behalf such a distribution is being made, or

(3) who is a broker-dealer or other person who has agreed to participate or is participating in such a distribution,

directly or indirectly, . . . to bid for or purchase for any account in which he has a beneficial interest, any security which is the subject of such distribution. . . ."

17 C.F.R. § 240. 10b-6 (1973)

Findings of Fact

1. During the year 1972, and for many years prior thereto, James Cowdon Bradford ("Bradford") was managing partner of J. C. Bradford & Co. ("Bradford & Co."), a broker-dealer in securities; president and a director of Life Stock Research Corporation ("Life Stock"). The Bradford family owns approximately 66⅔ % of Bradford & Co.

2. During 1972, James Cowdon Bradford, Jr. ("Bradford, Jr.") was a partner of Bradford & Co., vice-president and director of Life Stock, and until August, 1972, was a director of Old Line Life Insurance Co. ("Old Line").

3. During 1972, Life Stock served as a registered investment advisor to Life Insurance Investors, an open-end invest-

ment company or mutual fund which invests in life insurance securities, sells investment shares to the public and is registered with the SEC pursuant to § 8 of the Investment Company Act of 1940.

4. During 1972, and for several years prior thereto, Bradford & Co., Inc., wholly owned by Bradford & Co., owned 81% of the voting capital stock of Life Stock, and the Bradford Foundation, a charitable trust controlled by the Bradford family, owned the remaining 19% of the voting capital stock of Life Stock.

5. During 1972, and for several years prior thereto, Bradford and Bradford, Jr., members of their families, partners and employees of Bradford & Co., Life Insurance Investors, Inc., and Life Stock owned in the aggregate as much as 17% of all shares of Old Line stock outstanding.

6. As of April 1, 1972, Bradford owned approximately 50,000 shares of the common stock of Old Line, representing approximately 5% of the outstanding stock of Old Line; and after the declaration of a 20% stock dividend by Old Line on May 25, 1972, Bradford owned approximately 60,601 shares of Old Line common stock. During the year 1972, and for approximately eleven years prior thereto, Bradford had owned approximately 5% of the outstanding stock of Old Line.

7. During the year 1972, and for approximately eleven years prior thereto, Life Insurance Investors, Inc. owned approximately 8% of the outstanding shares of Old Line. As of April 1, 1972, Life Insurance Investors owned approximately 80,000 shares of the 1,080,000 shares outstanding, and after the declaration of a 20% stock dividend on May 25, 1972, by Old Line, Life Insurance Investors owned approximately 104,-510 shares of Old Line common stock outstanding.

8. In 1961, a controlling block of Old Line stock became available for purchase, and Bradford put together the syndicate

which purchased this stock. Bradford and Life Insurance Investors purchased approximately 5% and 8% respectively, which they continued to own through 1972, and the remainder of the block was purchased by other members of the syndicate put together by Bradford.

9. After purchase of this controlling block of Old Line stock by the Bradford group, Bradford became a director of Old Line, and after his retirement as a director, he was succeeded by his son, Bradford, Jr., who was a member of the Old Line Board until August, 1972; and from time to time, usually once a year, after the purchase, Forrest Guynn, President of Old Line, would come to Nashville to give Bradford a personal report on the affairs of the company.

10. After the purchase of the controlling block of Old Line stock by the Bradford group, Bradford & Co. acted as managing underwriter for two stock offerings of Old Line stock and also made a market in the stock and was known as a principal market-maker of the stock.

11. Prior to 1972, Old Line was considered in the insurance industry as a likely target for merger or takeover. Because of Bradford's relationship with Old Line, he received numerous approaches from companies interested in acquiring Old Line.

12. One of the factors Bradford would consider in determining his position about a prospective merger or acquisition of Old Line was whether the stock he would receive in exchange for his own Old Line shares was the kind of stock he could retain in his estate. His own personal investment and tax situation were factors to be considered in determining his petition about a prospective merger.

13. Gordon E. Crosby, chairman of USLIFE, first approached Bradford about acquisition of Old Line because it

was general knowledge in the insurance industry that Bradford had put together the syndicate which had acquired control of Old Line, and Crosby's investigations indicated that Bradford was the key individual with whom acquisition of Old Line should be discussed.

14. Crosby stated that USLIFE had an interest in discussing acquisition of Old Line in a telephone conversation with Bradford in October, 1971. Bradford advised Crosby that any offer for acquisition of Old Line which did not involve at least $50 for each Old Line share would be opposed by him. The market price of Old Line stock at that time was approximately $24 a share; Crosby advised Bradford that the market price of Old Line was such that it was unrealistic for USLIFE to pay $50 a share at that time.

15. On April 19, 1972, Crosby telephoned Bradford and reminded him that Bradford had named $50 per share of Old Line as the minimum starting price for consideration and stated that he (Crosby) was then in a position to work out a deal on a basis better than $50.

16. By letter to Bradford dated April 19, 1972, and received by Bradford on April 21, 1972, Crosby wrote as follows:

> "Based upon the analytical work that we [USLIFE] have completed, we believe **we are now in a position to offer an exchange ratio of one-for-one of 100% of Old Line Life. . . .**
>
> "When my associate, Don Manuel, visited with you in Nashville on November 19, 1971, **you apparently indicated that no consideration would be given to the possible sale of Old Line until such time as a price of somewhere around $50.00** could be realized. It would appear that developments have now been such that we can rather significantly exceed the prices you have previously mentioned.

> "I should say to you, Mr. Bradford, that in considering a 1-for-1 exchange ratio time is of the essence. This would create dilution for us on both a statutory and adjusted basis and we would want to consummate the transaction sufficiently early in a calendar year as to afford us the opportunity for taking action that would eliminate that dilution prior to year-end.
>
> "We are in a position to act decisively and promptly in this matter and I will therefore be looking forward to hearing from you further."
>
> (Emphasis added)

17. After receiving Crosby's April 19th letter on the morning of April 21st, Bradford called Crosby in order to discuss the possible acquisition of Old Line by USLIFE and requested that USLIFE discuss or negotiate the acquisition with no one other than Bradford without his approval. In response to Bradford's April 21st telephone call, Crosby wrote Bradford a letter dated April 21, 1972, as follows:

> "I'm assured that, from this point forward, neither I nor any of my associates will have discussion with anyone concerning the company in question other than yourself. As time goes forward, it hopefully will be desirable for us to have discussion directly with the officers of the company, but this would be done only with your full knowledge and approval.
>
> "You will find enclosed the form of finder's agreement that we have used is conjunction with our many prior acquisitions where a finder's fee was involved. If this is acceptable to you, we would be happy to prepare the appropriate letter for our respective signatures."

18. In keeping with Bradford's practice of settling finder's fees before negotiations commenced so that the fee is not negotiated as a part of the purchase price, in his telephone

conversation with Crosby on April 21, 1972, Bradford advised Crosby that if negotiations for acquisition of Old Line by USLIFE were successful, Bradford & Co., Inc. would expect a finder's fee equivalent to 1% of the fair market value of USLIFE common stock issued in exchange for Old Line. Crosby agreed. This was the first time negotiations with any company for the acquisition of Old Line had motivated Bradford to enter into a fee arrangement with the purchaser.

19. It is evident that Bradford realized the offer to negotiate was made in good faith. Furthermore, he realized that the parties intended to enter into serious negotiations to effect the merger and that such merger negotiations were likely to be successful.

20. On April 19, 1972, the closing bid price for the common stock of Old Line was $33 per share; on the same date, the closing price on the New York Stock Exchange of USLIFE was $61 per share.

21. On April 21, 1972, after receipt by Bradford of Crosby's letter confirming their conversation of April 19, 1972, and stating that he was willing to negotiate for acquisition by USLIFE of Old Line on a 1-for-1 basis, Bradford caused to be purchased for the account of his wife, Eleanor A. Bradford, 2,000 shares of common stock of Old Line, as follows: 100 shares at $33 per share; 100 shares at $33¼ per share; 300 shares at $34 per share; and 1,500 shares at $34¼ per share.

22. Between April 21, 1972, and April 26, 1972, after receipt by Bradford of Crosby's letter confirming their conversation of April 19, 1972, and stating that he was willing to negotiate for acquisition by USLIFE of Old Line on a 1-for-1 basis, Bradford caused to be purchased for the account of Life Stock, 5,400 shares of common stock of Old Line, as follows: On April 21, 1972, 200 shares at $34¼ per share, 300 shares at

$34⅝ per share, 300 shares at $34¾ per share, and 200 shares at $34⅞ per share and 1,100 shares at $36⅜ per share.

23. On April 27, 1972, after learning from Bradford of Crosby's conversations with Bradford, the defendant, Bradford, Jr., purchased for his own account 1,225 shares of common stock of Old Line at $37 per share.

24. Bradford and Bradford, Jr. had not purchased shares of Old Line for their accounts or the accounts of members of their families for more than eight years prior to their purchases in April, 1972, except for 1,000 shares of Old Line purchased for Mrs. J. C. Bradford, Sr. on December 23, 1969.

25. On May 15, 1972, Bradford called Crosby advising that he was undergoing surgery and would be out of the office for a few days and Crosby made a contemporaneous memorandum of the conversation which reads in part as follows:

> "I received a long distance telephone call from J. C. Bradford this morning who says he has had several discussions with Forrest Guynn [chief executive officer] of Old Line Life, and they would like to prepare to have serious negotiations with us. . . .
>
> "Bradford said Old Line has their annual shareholders' meeting on May 18th at which time pursuant to prior announcement they will be declaring a 20% stock dividend which would increase the current outstanding shares from one million, eighty thousand. I told Bradford this would be no problem because we would simply modify our arithmetic accordingly and that if we had in fact been thinking of a 1-for-1 this would then become 8/10-for-1.
>
> "Bradford then inquired as to when we would make a public announcement of our deliberations. I told him that would be at the time we signed a letter of intent. He

then asked what my preference was for taking such action and I told him probably mid-June. He responded, 'that will be fine.' "

26. On June 7, 1972, Bradford called for Crosby by telephone and finding Crosby not in his office left a message with Crosby's secretary which she forwarded to Crosby as follows:

> "Mr. Bradford reported that he had just started his return to work for a few hours each morning and that Forrest Guynn of Old Line had wanted to come see him this week but Mr. Bradford did not feel up to it.
>
> "Mr. Bradford did say that Mr. Guynn will be visiting him in Nashville on Monday, June 19, and until after such visit, Mr. Bradford would have nothing specific to report to Mr. Crosby."

27. On June 8, 1972, Crosby wrote Bradford stating in part:

> "Mrs. Hogan has, of course, relayed to me your message that Mr. Guynn is scheduled to visit with you in Nashville on Monday, June 19th. Naturally, I am hopeful that that discussion will prove to be productive and that it will be possible for us to meet together very shortly thereafter, hopefully finalizing an agreement to move forward with our proposed acquisition of 100% of Old Line Life."

28. On June 20, 1972, Bradford called Crosby by telephone to advise that he (Bradford) had met with Guynn on June 19, 1972, and that Guynn would be willing to meet with Crosby to receive his offer. In that telephone conversation, arrangements were made for Crosby to fly to Milwaukee, Old Line's home office, on June 28, in order to meet with Guynn on June 28th and June 29th. Crosby confirmed this arrangement with Guynn by letter dated June 20, 1972, which, after discussing plans respecting the June 29th meeting in Milwaukee, states:

> "My letter to you dated April 21st, sent along a suggesting finder's fee agreement along with our form of employment contract and other information. I would suggest it would be desirable from both our points of view that we finalize our understanding with respect to the finder's fee as expeditiously as possible hopefully in advance of my meeting with Mr. Guynn."

29. On June 26, 1972, a representative of USLIFE delivered to Bradford in Nashville an agreement whereby Bradford & Co., Inc. would receive a finder's fee equivalent to 1% of the fair market value of USLIFE common stock issued in exchange for Old Line; and this finder's fee agreement was executed on June 26, 1972. At the same time the USLIFE representative delivered to Bradford a 40 page brochure which Crosby intended to deliver to and discuss with Guynn at his meeting in Milwaukee on June 29th. This brochure, containing information about the proposed acquisition, included information about the finder's fee agreement between USLIFE and Bradford.

30. After reviewing the brochure delivered on June 26, 1972, Bradford discussed with Bradford, Jr. the inclusion of the finder's fee information in the brochure which the directors and perhaps others would review. Bradford advised Bradford, Jr. that it would be inadvisable to put the finder's fee information in the brochure, but it should be stated in a separate letter and verbally when the directors met to consider the acquisition of Old Line by USLIFE. On June 27, 1972, Bradford called Crosby to ask that the finder's fee agreement between USLIFE and Bradford be deleted from the brochure.

31. On June 28-29, 1972, Crosby met with Guynn in Milwaukee. This was his first meeting or communication about the acquisition with Guynn as the chief executive officer of Old Line. Prior to this time, Crosby had not conducted negotiations respecting the acquisition of Old Line by USLIFE with any-

one other than Bradford. At this meeting Crosby presented to Guynn the 40 page brochure. Crosby offered an exchange ratio of 0.8 shares of USLIFE for 1 share of Old Line, or phrasing it differently, 10 shares of Old Line for 8 shares of USLIFE. This exchange ratio was different from and below the exchange ratio of 0.833 share of USLIFE for 1 share of Old Line which would have been the exchange ratio if the exchange were on a share for share basis, as originally proposed, taking into account the 20% stock dividend declared by Old Line in May, 1972. Crosby was unwilling to acquire Old Line stock at an exchange ratio of 0.833 shares of USLIFE for each share of Old Line and advised Guynn that his price of 0.8 shares of USLIFE for each share of Old Line was not negotiable.

32. Crosby describes the results of the June 28-29, 1972 meeting with Guynn as follows:

> ". . . I urged him [Guynn] to sign a letter of intent which was not binding on his Board and it was not binding on my Board. Then putting out a press release and the brochure to which we are referring or copies of the letter of intent and there are copies of some alternative press releases.
>
> "We had considerable discussion at this point and Mr. Sell, counsel to Mr. Guynn, took the position that because of Mr. Guynn's relationship with his Board was different from our relationship with my Board, he did not think Mr. Guynn would be well advised to sign a letter of intent without first getting Board authorization to do so.
>
> "I said well, I respect your judgment, I don't agree but I'm not going to tell you how to run your company, but I'm going to put out a press release because I have made a firm offer which you are now going to be in a position of discussing with your Board and I'm not going to take the risk of disclosure.

> "I picked up the telephone in their presence and called Mr. Davey [counsel for USLIFE] and gave him a press release to put out on the Dow-Jones which went out in a matter of 10 or 15 minutes.
>
> "Subsequently . . . the Old Line Board did meet and did authorize Mr. Guynn to execute the letter of intent which I had signed that day and put in escrow with Mr. Sell."

33. The press release of June 29, 1972, issued by Crosby and carried in the Wall Street Journal on June 30, 1972, was the first public disclosure of any kind concerning the proposed acquisition of Old Line by USLIFE. The Wall Street Journal story on June 30, 1972, reads in part as follows:

> "Reached in Milwaukee, Forrest D. Guynn, President of Old Line Life, said he **'could be' surprised at the offer. 'I haven't had that much opportunity to study** USLIFE'S figures at all,' he said, adding that for that reason he couldn't comment further.
>
> "Under terms presented to Old Line, USLIFE would acquire each Old Line outstanding share for 0.8 share of USLIFE common. The transaction would involve 1,036,000 USLIFE shares, the company said." (Emphasis added.)

34. On July 7, 1972, the Board of Directors of Old Line met to consider the USLIFE offer. Bradford, Jr. attended this meeting as a director. Prior to the Director's meeting, Bradford and Bradford, Jr. agreed that the USLIFE offer to acquire each Old Line outstanding share of .8 share of USLIFE common stock should be accepted, subject to stockholder approval, if no higher exchange ratio could be obtained, but that first a counter offer should be made for the acquisition of each Old Line share for 0.833 shares of USLIFE common. Bradford, Jr. presented this to the Board as his and his father's position. USLIFE rejected the counter proposal and Guynn, with his Board's authorization,

entered into an agreement in principle providing for the acquisition of each Old Line share for 0.8 share of USLIFE, subject to the approval of two-thirds of the stockholders of Old Line and the approval of necessary regulatory bodies, and an audit of the books of Old Line.

35. On July 11, 1972, USLIFE issued a press release containing a joint announcement by Crosby and Guynn that the parties had "reached an agreement in principle" by which USLIFE would acquire Old Line and that "under the terms of the agreement reached today 0.80 of a share of USLIFE common stock will be exchanged for each share of Old Line Life common stock." On July 14, 1972, Guynn sent a copy of the July 11, 1972 press release to the stockholders of Old Line. The July 11, 1972 press release and the July 14, 1972 stockholders letter sending a copy of the press release were the second public disclosures of information respecting the acquisition of Old Line by USLIFE.

36. After the execution of the letter of intent, the issuance of the press release of July 11, 1972, and the stockholder letter of July 14, 1972, Bradford, Old Line and USLIFE determined that the merger could not be consummated unless the SEC entered an order pursuant to § 17(b) of the Investment Company Act of 1940, 15 U.S.C. § 80(a)—17(b), exempting the merger from the provisions of § 17(a) of the Act. The reason it was necessary to obtain SEC approval of the merger was the large number of shares of Old Line stock owned by Life Insurance Investors, Bradford and his family and the partners of Bradford & Co.

37. After learning that SEC approval was advisable, Crosby and Guynn issued a joint press release on August 31, 1972, saying:

> ". . . because of certain unanticipated problems, the meeting of shareholders of Old Line Life to vote on a proposed acquisition of the company by USLIFE has been

> postponed. The meeting was to have been held on September 27, 1972. The problems, which involve approvals by State and Federal regulatory agencies, must be resolved before the meeting can be held.
>
> "Mr. Crosby said: 'As soon as we can determine whether these matters can be resolved and whether the transaction can be closed no later than December 31, 1972, as originally contemplated, a further announcement will be made.' "

This was the third public disclosure of information about the acquisition of Old Line by USLIFE. No other public disclosure was made prior to the action of the SEC on November 10, 1972 charging the defendants with fraud under Rule 10b-5 and the action of the SEC on November 20, 1972 approving the merger.

38. On or before September 1, 1972, a date prior to the filing of an application for approval of the merger by the SEC, Bradford and Crosby were advised by their lawyers that the SEC would not approve the merger without a hearing if Bradford insisted on enforcement of his finder's fee agreement with USLIFE. On Labor Day, 1972, Bradford and Crosby, through their lawyers, Anthony Davey and William Waller, Jr., negotiated a new agreement on this subject. Crosby called Waller and advised him that if the finder's fee was not waived by Bradford that day, Crosby would issue a press release calling the deal off before the market opened the next morning. Waller called Bradford, who was in Linville, North Carolina on vacation, and relayed this message. Bradford responded by telling Waller to call USLIFE and tell them that he would agree to waive the fee only if the stockholders received sufficient additional shares of USLIFE in exchange for Old Line shares to be equivalent to the amount of the finder's fee. Bradford further advised Waller that unless Crosby accepted this proposal, "let them issue their statement or press release" calling off the deal.

Bradford did not confer with any director or officer of Old Line about this decision, again demonstrating his position of control and dominance concerning the affairs of Old Line and the acquisition negotiations with USLIFE. This negotiation took place during a few hours on one day, i.e., Labor Day, 1972. Crosby agreed to Bradford's proposal and the exchange ratio was increased from 0.8 to 0.808 share of USLIFE for each share of Old Line.

39. On September 25, 1972, Life Insurance Investors, Old Line, Bradford, Bradford & Co., and certain applicants filed an application with the SEC for orders exempting the acquisition of Old Line by USLIFE from the provisions of § 17(a) of the Investment Company Act of 1940, 15 U.S.C. § 80(a)-17. On or about October 9, 1972, the same parties, at the request of the SEC, submitted a supplement to their application for exemption under § 17(a) of the Investment Company Act of 1940, which advised the SEC of the transactions in Old Line stock in April, 1972, by Bradford, Bradford, Jr., and Life Stock.

40. The SEC, in August, September, October and November, 1972, was conducting an investigation of the merger, the finder's fee arrangement, the relationship of Life Insurance Investors, Life Stock, Bradford & Co. and Bradford & Co., Inc. On November 20, 1972, the SEC approved the merger of Old Line and USLIFE.

41. On December 28, 1972, after a meeting of the stockholders of Old Line on December 20, 1972, approving the merger, the acquisition of Old Line by USLIFE became effective.

42. Bradford & Co., through John Gwynn, its security analyst in charge of life insurance stocks, consistently recommended Old Line for purchase in written recommendations to its salesmen and in Gwynn's oral conversations with the salesmen. Gwynn discussed Old Line and his recommendations of

the stock with Bradford and Bradford, Jr. The last such confidential recommendation to salesmen was dated October 19, 1972, and tells them, in effect, not to be concerned about the recent price decline and sell-off in Old Line and states that the SEC has not rendered its decision on the merger and that the sell-off is not based on information not available to Bradford & Co.

43. Bradford & Co. was a principal market-maker in Old Line stock throughout the year 1972. In trading in the stock of Old Line as a market-maker, Bradford & Co., during the year 1972, purchased 169,054 shares and sold 170,685 shares and made a profit for the year in its trading account on these sales and purchases in the amount of $103,214.15. Approximately $75,000 of this profit on trading activity in Old Line was made in the months of April through December, 1972.

44. The market in Old Line stock was maintained in the over-the-counter market, an essentially anonymous market like the market for securities maintained by the New York Stock Exchange and other securities exchanges. The New York Stock Exchange is an auction market so that for a New York Stock Exchange listed security, there is a specialist or market-maker on the floor of the Exchange who handles the transactions in a particular stock. A trade is consummated when a broker with an order from his customer to buy or sell a security goes to the specialist who either matches the order against one or more buy or sell orders placed with him by other brokers, or, if necessary, if there is an imbalance in the market, the specialist buys or sells the stock for his own account in order to make the market. The specialist is obligated to buy and sell securities at quoted prices in order to maintain the market in a security. In the over-the-counter market, a market in a security is maintained in basically the same way as on an Exchange, except that in the over-the-counter market, there may be more than one specialist or book in the stock. This specialist is called a market-maker and he

offers and obligates himself to buy and sell a particular security at quoted prices. Such a specialist or market-maker advertises his quotations by placing bid and asked quotations on the security in the "NASDAQ" system or the "pink sheets" published daily by the National Quotations Bureau. A broker with an order to buy or sell a security in the over-the-counter market, as on the New York Stock Exchange, would contact a specialist or market-maker. This would usually be done by telephone instead of on the floor of the exchange. The market-maker would buy or sell the security based on his quotations, adjusting his prices on the basis of the supply and demand for the stock. The market-maker in the over-the-counter market, just as on the New York Stock Exchange, is risking his own capital, seeking to make a profit from his trading activity by judging the demand and supply of the stock and the direction of the price.

45. Bradford, Jr. purchased 1,225 shares of Old Line on April 27, 1972, for $45,325 and sold those same shares, increased by the 20% stock dividend, on July 31, 1972, at $39¾ per share for $58,432, realizing a profit of approximately $13,000. Life Stock purchased 5,400 shares of Old Line on April 21, 25, 26, 1972 at an average price of approximately $298,000, realizing a profit of approximately $103,000. Bradford purchased 2,000 shares for his wife on April 21, 1972, and on December 27, 1972, the last business day before the merger took effect, the bid price of Old Line shares according to the Wall Street Journal was $59¼ per share, and on that day the unrealized market value of those same shares was approximately $142,200, and the unrealized profit on those shares on that day was approximately $74,000.

46. The bid and asked price and volume of Old Line shares traded in the over-the-counter market, as reported in the Wall Street Journal, and the same information for USLIFE shares traded on the New York Stock Exchange, as reported in the Wall Street Journal, are given in the following table:

OLD LINE LIFE INSURANCE

Date	Sales	Bid	Asked
1/03/72	600	23	23½
1/04/72	1400	23	23½
1/06/72	5800	24	24½
1/10/72	4400	26½	27
1/13/72	1700	27⅜	27⅞
1/18/72	1800	26¾	27¼
1/20/72	900	27¼	27¾
1/24/72	2000	27½	28
1/27/72	1000	29½	30¼
2/01/72	1800	28⅝	29⅜
2/04/72	2400	29	29¾
2/08/72	3300	30¼	31
2/11/72	1200	29¼	30
2/14/72	300	29	29¾
2/17/72	2000	29	29¾
2/22/72	6000	31	31¾
2/25/72	x2800	30¾	31½
2/28/72	1700	30¾	31½
3/03/72	300	31	31¾
3/06/72	6700	31	31¾
3/09/72	2300	31	31¾
3/14/72	9100	34¾	35½
3/16/72	1300	35¾	36½
3/20/72	600	36¾	37½
3/23/72	3100	36	36¾
3/27/72	1600	36	36¾
3/30/72	4900	34¾	35½
4/04/72	700	34¼	35
4/05/72	700	34¼	35

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Date	Sales	Bid	Asked
4/06/72	2300	34½	35¼
4/07/72	400	34¾	35½
4/10/72	900	34½	35¼
4/11/72	400	34¼	35
4/12/72	1500	34	34¾
4/13/72	400	34	34¾
4/14/72	1200	33½	34¼
4/17/72	1000	33¼	34
4/18/72	700	33¼	34
4/19/72	1600	32⅝	33⅜
4/20/72	4000	32¼	33
4/21/72	1600	32¼	33
4/24/72	6500	34½	35¼
4/25/72	2900	35	35¾
4/26/72	5700	36	36¾
4/27/72	3300	35¾	36½
4/28/72	4000	37	37¾
5/01/72	3500	38½	39¼
5/02/72	1700	38¾	39½
5/03/72	4800	36½	37¼
5/04/72	1700	37¼	38
5/05/72	4500	36¾	37½
5/08/72	2400	36	36¾
5/09/72	z2400	36	36¾
5/10/72	1100	35¼	36
5/11/72	200	35¼	36
5/12/72	500	35	35¾
5/15/72	1900	35	35¾
5/16/72	1400	35¼	36
5/17/72	1000	35¼	36
5/19/72	6400	36½	37¼
5/22/72	1300	36¼	37
5/23/72	1700	36½	37¼

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Date	Sales	Bid	Asked
5/24/72	1200	35½	36¼
5/26/72	x1500	29	29¾
5/30/72	200	29	29¾
5/31/72	300	28¾	29½
6/01/72	400	28¼	29
6/02/72	z4000	28¼	29
6/05/72	800	28¼	29
6/06/72	400	28	28¾
6/07/72	500	27¾	28½
6/08/72	400	27¾	28½
6/09/72	3900	28¾	29½
6/12/72	100	28¾	29½
6/13/72	20300	32¼	33
6/14/72	7900	32½	33¼
6/15/72	3400	31¾	32½
6/19/72	3700	33¾	34½
6/20/72	10700	36½	37½
6/21/72	10100	36¼	37
6/22/72	6400	40	41
6/23/72	10900	39	40
6/26/72	8700	39¼	40
6/27/72	5700	39¼	40
6/28/72	4000	39	39¾
6/29/72	2200	38¼	39
6/30/72	14000	39¾	40½
7/03/72	14300	39½	40
7/05/72	2800	39½	40¼
7/06/72	3500	39½	40¼
7/07/72	12000	39⅞	40⅝
7/10/72	11700	40	40¾
7/11/72	3500	40	40¾
7/12/72	11200	40¼	41¼

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Date	Sales	Bid	Asked
7/13/72	6800	41	42
7/14/72	19200	40	41
7/17/72	6800	39½	40½
7/18/72	12000	39⅜	40⅜
7/19/72	22000	39	40
7/20/72	3600	39½	40½
7/21/72	2200	39½	40½
7/24/72	30900	49¼	40¼
7/25/72	6600	39½	40½
7/26/72	3900	39⅛	40⅛
7/28/72	2500	39	40
7/31/72	6100	39¼	40¼
8/01/72	1200	39½	40½
8/04/72	12100	42½	43½
8/08/72	3500	43½	44½
8/11/72	51300	42	44
8/14/72	20500	42	44
8/17/72	25100	44½	46½
8/21/72	1800	44½	46½
8/24/72	1000	46	48
8/29/72	x3900	44½	46½
9/05/72	4600	37	40
9/07/72	6700	39	41
9/11/72	14800	43	45⅞
9/14/72	7000	43½	45½
9/18/72	1000	43¾	46¾
9/22/72	700	43½	46½
9/26/72	500	43½	45½
9/29/72	1600	44¾	46
10/02/72	2100	45	47
10/05/72	1300	46½	48
10/09/72	4200	45¾	47¾

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Date	Sales	Bid	Asked
10/12/72	—	47	50
10/16/72	6400	45½	48½
10/20/72	5000	40	43
10/24/72	8900	43	47
10/26/72	1100	40	45½
10/30/72	5400	47	50
11/02/72	9100	49¾	52¾
11/06/72	5500	51½	54½
11/09/72	1100	52½	55½
11/13/72	13400	53	58
11/17/72	5900	55	60
11/21/72	1200	58	57½
11/24/72	800	53	55¾
11/28/72	2700	54½	59½
12/01/72	500	55	57
12/05/72	1900	55½	57½
12/08/72	2200	58	60
12/11/72	2700	58½	60½
12/14/72	2600	57¾	60¾
12/19/72	1700	56¾	59¾
12/22/72	5200	58¾	60¾
12/27/72	x200	59¼	61¼
12/29/72	1300	59¼	61¼

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USLIFE

Date	Sales	Open	High	Low	Close	Bid Change
1/06/72	7600	47	47¼	47	47¼	+ ⅜
1 11/72	3100	47½	47½	46¾	46⅞	− ⅞
1/18/72	4400	46¼	46⅜	46	46⅜	+ ⅜
1/28/72	17100	45⅝	45⅞	44¾	45	− ⅝
2/01/72	8100	45⅜	45⅜	45⅜	44½	− 1
2/08/72	35700	47⅛	47½	46¾	46⅞	+ ¼
2/14/72	21900	46⅞	47⅜	46⅝	47⅛	+ ⅝
2/22/72	7500	46⅜	46⅝	46⅛	46⅝	+ ¼
3/01/72	20400	49	49½	48⅝	49½	+ ⅝
3/08/72	11300	56	56⅛	54⅝	55¾	+ ¼
3/15/72	5900	54⅜	54⅜	53¼	53⅜	− 1⅛
3/21/72	11300	55½	56½	55½	56¼	+ 1
3/28/72	12600	56⅜	56¾	56⅜	56¾	
4/05/72	11400	56¼	57	55⅝	57	+ ⅜
4/12/72	8200	61	62½	61	62⅛	+ ⅞
4/19/72	7100	60⅜	61¼	60⅜	61	+ ¾
4/26/72	11000	60⅜	60½	59¾	59¾	− ⅞
5/02/72	13300	59⅞	60¼	59¾	60	+ ⅜
5/10/72	8500	58¼	58¼	57¼	58	− ⅛
5/17/72	3100	59	59½	59	59½	+ ¾
5/24/72	4600	59¾	60	59⅝	60	+ ¼
5/31/72	5100	58⅝	59¾	58⅝	59¾	+ 1⅛
6/07/72	3000	59⅜	59½	58⅝	58⅝	− 1⅛
6/14/72	6500	57	57⅜	55⅞	56⅜	− ½
6/21/72	9000	59	60	58⅝	59¾	+ ¾
6/28/72	900	58½	58½	58¼	58¼	

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Date	Sales	Open	High	Low	Close	Bid Change
7/05/72	1700	57	57⅛	57	57⅛	
7/12/72	12000	56	56⅛	55	56⅛	− ¼
7/19/72	8800	55	55	54¼	54⅝	− ½
7/26/72	13300	55⅛	55⅝	54½	54½	− 1¼
8/02/72	2300	54⅞	55	54⅞	55	+ ⅛
8/08/72	3200	59	59½	59	59⅜	+ ⅜
8/11/72	5500	61¾	61¾	61	61	− 1
8/24/72	8100	63⅛	63¼	62¾	62¾	− ⅛
8/29/72	4000	61¾	61⅞	61⅛	61⅛	− ½
9/06/72	3800	60⅞	61	60¾	61	
9/13/72	x34200	59½	59⅝	59	59½	− ⅝
9/20/72	5800	60⅛	60⅜	60	60	− ¼
9/27/72	14300	60¼	61⅜	60⅛	61⅜	+ 1⅛
10/04/72	17500	63½	64	63⅝	63¾	− ¼
10/10/72	7300	65	66	65¼	66	+ 1
10/18/72	5900	64¼	63¾	63⅛	63¾	− ½
10/25/72	5500	67½	67¾	67½	67½	
10/31/72	14900	67¾	68½	67¾	68¼	+ ½
11/09/72	16900	73½	74¾	73	73	− ½
11/14/72	13500	74⅛	73⅝	71¾	71¾	− 2⅜
11/21/72	14900	71⅞	71¾	71	71	− ⅞
11/29/72	6400	70⅝	72¼	71⅝	71⅛	+ ½
12/05/72	4600	70⅞	72¼	70⅞	72	+ 1⅛
12/14/72	7000	75½	75⅛	73½	73⅞	− 1⅝
12/19/72	22100	73	72⅞	72⅛	72¾	− ¼
12/27/72	7800	74	74⅜	74⅛	74⅜	+ ⅜

47. In its market-making and trading activity in Old Line stock in 1972, Bradford & Co. maintained a generally long position in the stock, i.e., was a net purchaser on balance of Old Line stock for the months of January through May, 1972, and for the month of June was a net seller on balance of Old Line stock in the amount of approximately 5,000 shares.

48. The day to day operations of the trading department at Bradford & Co., including trading in Old Line stock, during 1972, were conducted by or under the immediate supervision and control of Larry Wahl, manager of the over-the counter trading department; and the activities of the department were under the general supervision of Bradford, who supervised and set the policy for the operation of the department and reviewed the department's position in securities in which the company made a market.

49. The Old Line stock acquired in April, 1972, by Bradford for his wife and by Bradford, Jr., and 3,400 shares of the stock purchased by Bradford for the account of Life Stock were purchased from inventory of Bradford & Co. The remaining 2,000 shares for the account of Life Stock were purchased from Bache & Co., another broker-dealer, with Bradford & Co. acting as agent. Wahl, the manager of the trading department, handled the mechanics of these transactions.

50. Throughout the negotiations for the acquisition of Old Line by USLIFE, Bradford was acting for the stockholders of Old Line.

51. From April 1, 1972, until November 20, 1972, the date of the approval of the merger by the SEC, the only public disclosures of information respecting USLIFE's acquisition of Old Line were the press release of June 29, 1972, July 11, 1972 and August 31, 1972, described in paragraphs 33, 35 and 37 above.

52. On May 18, 1972, (trade date) plaintiff Fridrich purchased 500 shares of Old Line stock at $37¾ per share, and on June 15, 1972, (trade date) he sold those same shares, including an additional 100 shares received as a result of the 20% stock dividend declared during the interim by Old Line, for $32½ per share, receiving a total of $19,500 for the 600 shares sold. He purchased and sold these shares upon the advice of his broker, Kenneth B. Schoen. Schoen is a registered representative, broker and assistant vice-president employed in the Nashville office of A. G. Edwards & Sons.

53. On May 18, 1972 (trade date), plaintiff Kim purchased 500 shares of Old Line and on June 15, 1972 (trade date), sold 600 shares, including the 20% stock dividend declared by Old Line, at $32.50 a share, receiving a total of $19,500. Kim purchased and sold her stock on the recommendation of Schoen.

54. The Woosley family group on June 13, 14, 15, 1972 (trade dates), sold 12,718 shares of common stock of Old Line receiving therefor the sum of $418,006.25. The family purchased this stock prior to 1967 through Bradford & Co. This stock was sold upon the the advice of their broker, Ken Schoen. The name of each member of the family group. the number of shares sold, the date of sale and the price are set out below:

Name	Number of Shares	Date of Sale	Price Per Share	Amount Received
W. Bryant Woosley	90	6/14/72	32½	2,925.00
(Deceased)	112	6/15/72	33¼	3,724.00
	186	6/15/72	33¼	6,184.50
	4,000	6/15/72	32¼	130,000.00
	2,000	6/15/72	33	66,000.00
	6,388			208,833.50
Lula L. Woosley	1,000	6/13/72	32½	32,500.00
	64	6/14/72	32½	2,080.00
	3,400	6/15/72	33¼	113,050.00
	4,464			147,630.00
William B. Woosley, Jr.	266	6/13/72	33½	8,911.00
	359	6/14/72	32½	11,667.50
	458	6/15/72	33¼	15,228.50
	66	6/14/72	32½	2,145.00
	9	6/15/72	33¼	299.00
	48	6/14/72	32½	1,560.00
	13	6/15/72	33¼	432.25
	1,219			40,243.25
Elizabeth M. Woosley	32	6/14/72	32½	1,040.00
(as custodian for	10	6/14/72	32½	325.00
children)	6	6/15/72	33½	199.50
	2	6/15/72	33¼	66.50
	50			1,631.00
Harry L. Woosley	284	6/14/72	32½	9,230.00
(for self and as	151	6/13/72	33½	5,058.50
custodian for	47	6/14/72	32½	1,527.50
children)	72	6/13/72	33½	2,412.00
	43	6/13/72	33½	1,440.50
	597			19,668.50

55. Schoen advised Fridrich, Kim and the Woosley family to sell the aforementioned stock after investigating the earnings of Old Line and seeking the advice of three individuals who are security analysts for registered investment companies or mutual funds. These three individuals specialize in life insurance stocks. Schoen relied primarily upon the advice of Mike Conn, who until September, 1972, was the insurance specialist or analyst for Bradford & Co., and in 1972 was the life insurance analyst or specialist for a mutual fund in Philadelphia. Schoen had a number of conversations with Conn in 1972 about the advisability of selling Old Line and concluded that when Old Line reached a market price of approximately $40 a share (prior to any adjustment for the 20% stock dividend in May) it would be advisable for his customers to sell. Schoen would not have advised his customers to sell on or about June 15, 1972, had he known that Bradford and Crosby were discussing the acquisition of Old Line by USLIFE on a 1-for-1 basis of exchange or a 0.80 basis. He would not have advised his customers to sell had he known that it was Bradford who was negotiating with USLIFE, that USLIFE had agreed to pay Bradford a finder's fee of 1% of the exchange value of USLIFE and that Bradford was continuing during the negotiations to be a principal market-maker in Old Line stock.

56. Schoen learned of the merger for the first time in mid-July, 1972. He did not advise Fridrich, Kim and the Woosley family to re-enter the market to purchase Old Line stock for a combination of reasons including the rise in price, his opinion and judgment that the market in Old Line was being influenced by inside information not in his possession and later on by rumors that the merger might not go through because of violations of the securities laws.

57. The stock sold by Fridrich, Kim and the Woosley family group on or about June 15, 1972, was purchased by A. G.

Edwards & Sons, and sold by Edwards on the same date at a profit of approximately one-half point a share to Middendorf-Colgate & Co., a market-maker in the stock of Old Line.

Conclusion of Law

I. General Propositions of Law

1. Rule 10b-5 is based on the Congressional purpose, and on the justifiable expectation of investors in the securities market-place, that all investors in a security trading on exchanges and in the over-the-counter market have relatively equal access to material information about the security; and insiders with access to information intended to be available only for a corporate purpose and not for the personal benefit of anyone may not take advantage of such information knowing it is unavailable to the investing public. **Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,** F.2d (2nd Cir., April 3, 1974, No. 73-1677), affirming **Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,** 353 F.Supp. 264 (S.D.N.Y. 1972) (District Court opinion containing exhaustive discussion); **SEC v. Texas Gulf Sulphur Co.,** 401 F.2d 833, 848, 851-52 (2nd Cir. 1968); **Mitchell v. Texas Gulf Sulphur Co.,** 446 F.2d 90 (10th Cir. 1971); **SEC v. Otis & Co.,** 106 F.2d 579 (6th Cir. 1939) ("obvious purpose of the Congress in its enactment [Exchange Act of 1934] was protection of the investing public"), affirming 18 F. Supp. 100 (N.D. Ohio 1936); **Astor v. Texas Gulf Sulphur Co.,** 306 F. Supp. 1333 (S.D.N.Y. 1969); H. R. Rep. No. 1383 on Securities Exchange Act of 1934, 73rd Cong. 2nd Sess. (1934). See generally, **The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers,** 57 **Corn. L. Rev.** 869-973 (1972). The Supreme Court states the purpose of § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 in **Affiliated Ute Citizens v. United States,** 406 U.S. 128, 151 (1972):

"These proscriptions, by statute and rule, are broad and, by repeated use of the word 'any' are obviously meant to be inclusive. The Court has said that the 1934 Act and its companion legislative enactments embrace a 'fundamental purpose to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.' **SEC v. Capital Gains Research Bureau,** 375 U.S. 186, 11 L.Ed. 2d 237, 243, 84 S.Ct. 275 (1963). In the case just cited the Court noted that Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes.' Id., at 195, 11 L.Ed.2d at 248. This was recently said once again in **Superintendent of Insurance v. Bankers Life & Casualty Co.,** 404 U.S. 6, 12, 30 L.Ed.2d 128, 134, 92 S. Ct. 165 (1971)."

2. Under Rule 10b-5, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities while such inside information remains undisclosed. A person is guilty of fraudulent conduct and breaches a legal duty to the investing public under the Rule when he trades in a security while in possession of material undisclosed information. See the authorities cited in paragraph 1, *supra*, In the **Affiliated Ute** case, *supra*, the Supreme Court, emphasizing the word "any" in the Rule, makes it clear that such action falls within the language of Rule 10b-5:

> "Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j, makes it unlawful 'for any person, directly or indirectly,' to 'employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention' of any rule 'the Commission may prescribe as necessary or appropriate in

the public interest or for the protection of investors.' One such rule so prescribed is rule 10b-5. This declares that, in connection with the purchase or sale of any security, it shall be 'unlawful for any person, directly or indirectly,' (1) 'To employ any device, scheme, or artifice to defraud,' (2) 'To make any untrue statement of a material fact or to omit to state a material fact so that the statements made 'in the light of the circumstances,' are misleading and (3) 'To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.' "

3. The Rule is applicable to any insider, and an insider is defined as anyone possessing material inside information, including any officer, director, stockholder, underwriter, market-maker or any tippee. See the Court of Appeals and District Court opinions in **Shapiro v. Merrill Lynch,** cited, *supra*, at paragraph 1.

4. An insider is not foreclosed from investing in his own company merely because he is more familiar with his operations than are outside investors, and in insider's duty to disclose information or abstain from dealing in the company's securities arises in those situations which are essentially extraordinary in nature and which are reasonably certain to have an effect on the market price of the security if disclosed. A comprehensive analysis of the effect of Rule 10b-5 as it applies to insider trading on impersonal exchanges appears in **Damages to Uninformed Traders for Insider Trading on Impersonal Exchanges,** 74 **Colum. L.Rev.** 299 (1974).

5. The test of materiality of information in 10b-5 nondisclosure cases is whether the information or facts withheld are of such a nature that a reasonable investor would consider them important in making his decision. Material facts include significant events or conditions which are likely to affect the desire of investors to buy, sell or hold the company's securities. See

cases cited, *supra*, at paragraph 1 and **Affiliated Ute Citizens** at 405 U.S. 128, 153-54, setting as the test of materiality "that the facts withheld be material in the sense that a reasonable investor might have considered them important in making his decision."

6. An insider trading with material inside information has a duty of disclosure to all investors trading in the same market, not just to the particular investor with whom he trades, and therefore, privity of contract between the insider and the plaintiff is not a necessary element in a private cause of action under 10b-5. **Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,** — F.2d — (2nd Cir. April 3, 1974, No. 73-1677), affirming **Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,** 353 F. Supp. 264 (S.D.N.Y. 1972) (District Court opinion containing exhaustive discussion); **Sargent v. Genesco, Inc.,** — F. 2d — (5th Cir. No. 72-3055, April 11, 1974); Cf. **Tex. Continental Life Insurance Co. v. Dunne,** 307 F.2d 242, 249 (6th Cir. 1962, where the Court appears to hold that privity is unnecessary because "if this were not so, the issuers and brokers could easily evade liability under the law because it is well known that the original purchasers of the securities do not always retain them as permanent investments and that the public trades in securities."); **SEC v. Texas Gulf Sulphur Co.,** 446 F. 2d 90 (10th Cir., 1971); **Astor v. Texas Gulf Sulphur Co.,** 306 F. Supp. 1333 (S.D.N.Y. 1969); H.R. Rep. No. 1383 on Securities Exchange Act of 1934, 73rd Cong. 2d Sess. (1934).

7. An insider's breach of a duty to disclose information before trading causes plaintiffs injury where the information withheld by the insider is material in the sense that such information is important and would be likely to affect the plaintiffs' decision to buy or sell. See, cases cited, *supra*, at paragraph 6.

8. An acquisition of securities of a corporation in exchange for securities of another corporation in connection with a merger, like a public offering of securities, constitutes a dis-

tribution of securities under Rule 10b-6 during the period when the terms of the acquisition agreement are being established and put into effect; and any broker-dealer participating in negotiation of the terms of such an acquisition engages in market manipulation in violation of Rule 10b-6 when, during such period of distribution, he trades in the securities being acquired. SEC Rule 10b-6, 17 C.F.R. § 240 (1973); **Criss-Craft Industries v. Bangor Punta Corp.,** 426 F.2d 569 (2nd Cir. 1970). See generally Jacobs, **Regulation of Manipulation by SEC, 18 N.Y.L. Forum,** 511, 534-42 (1973); Note **The SEC's Rule 10b-6: Preserving a Competitive Market During Distributions,** 1967 **Duke L. Jour.** 809.

9. A plaintiff, who sells securities not knowing of material information illegally withheld by defendant in violation of 10b-5, is entitled as damages to the difference between the price he receives for the securities sold and the highest value reached by the security within a reasonable time after the tortious conduct is discovered and full disclosure is made of the information wrongfully withheld. **Baumel v. Rosen,** 238 F. Supp. 128, aff'd 412 F.2d 571, 575-76 (4th Cir. 1969); **Mitchell v. Texas Gulf Sulphur Co.,** 446 F.2d 90 (10th Cir. 1971); **Restatement, Restitution** § 1516; **Restatement, Torts** § 927 e. See also **Affiliated Ute Citizens** at page 155:

> "In our view, the correct measure of damages under §28 of the Act, 15 USCS §78bb(a), is the difference between the fair value of all that the mixed-blood seller received and the fair value of what he would have received had there been no fraudulent conduct, see **Myzel v. Fields,** 386 F.2d 718 (CA8, 1967), cert.denied, 390 U.S. 951, 19 L.Ed.2d 1143, 88 S. Ct. 1043 (1968), except for the situation where the defendant received more than the seller's actual loss. In the latter case damages are the amount of the defendant's profit. See **Janigan v. Taylor,** 344 F.2d 781, 786 (CA1, 1965), cert. denied, 382 US 879, 15 L.Ed 2d 120, 86 S. Ct. 163 (1965)."

II. General propositions as applied to facts: legal conclusions

1. Applying the principles of law stated above to the facts of this case, during the relevant period of nondisclosure of April 19, 1972 (the date Crosby of USLIFE first contacted Bradford in order to acquire Old Line) through November 20, 1972 (the date the merger received SEC approval immediately following disclosure on November 10, 1972, by the SEC of defendants' conduct in violation of Rule 10b-5), the defendants were insiders in the stock of Old Line by virtue of the information in their possession, their position as members of the controlling group of stockholders of Old Line, their position as principal market-makers in Old Line stock and as agents of Old Line for the purpose of negotiating the terms of the merger with USLIFE. As insiders, the defendants knew or should have known that they possessed material information which it was their duty to disclose to the investing public before trading in the securities of Old Line. The material undisclosed information includes but is not limited to the following:

> (i) The fact that USLIFE in April, 1972, stated to Bradford its offer to acquire Old Line on a share-for-share exchange basis, when the sales price of Old Line (prior to the 20% stock split) was $33 and USLIFE was $61. Bradford and Crosby negotiated the terms of the merger which was presented to the Board of Old Line on July 7, 1972. The facts about the April offer to Bradford were not disclosed until the SEC brought suit against Bradford in November, 1972. USLIFE's interest in acquiring Old Line was first disclosed in a press release issued by Crosby on June 29, 1972, to which the president of Old Line publicly stated that he was "surprised" by the proposal and had not had "much opportunity to study the figures." Old Line's interest in the merger was first disclosed in a press release of July 11, 1972 announcing an agreement in principle between Old Line and USLIFE to merge.

(ii) The fact that the merger could not take place without SEC approval and that the effectuation of the merger was delayed awaiting the results of the SEC's investigation of Old Line stock ownership by Bradford and Bradford-controlled companies and Bradford's trading activity in Old Line stock and Bradford's finder's fee arrangement. These facts were not disclosed prior to the action of the SEC on November 10th and 20th, 1972.

(iii) The fact that Bradford and USLIFE agreed in April upon a 1% finder's fee (approximately $600,000) to be paid to Bradford & Co., Inc.; and in order to assure SEC approval of the merger, the finder's fee agreement was changed in September so that the exchange ratio or sales price of Old Line share was increased by the amount of the finder's fee. The fact of the increase in the Old Line exchange ratio was disclosed at the time the Old Line shareholders voted to approve the merger in December, 1972, but the other facts regarding the finder's fee were not disclosed prior to the merger.

(iv) The fact that USLIFE through Crosby agreed in April at Bradford's request to conduct the negotiations with respect to the merger solely with Bradford and not to discuss it with other representatives of Old Line without Bradford's approval and that Bradford and his company continued to act as principal market-makers effectuating a substantial percentage of the trades in Old Line stock while he engaged in and controlled the merger negotiations and while he furnished information to and negotiated with the SEC respecting approval of the merger. Bradford's relationship of control over the merger negotiations while acting as principal market-maker and Bradford's position on what the terms of the merger should be were not disclosed prior to the effectuation of the merger. If Bradford had determined to cease his activities as a principal market-

maker on April 19, 1972, the court cannot but conclude that since he was recognized in the industry as a controlling figure in Old Line (or at least a member of the syndicate which bought and controlled the company), a substantial import would have been felt in the market-place and the buying public would have been alerted that something unusual was occurring.

2. The defendants engaged in three (3) types of unlawful trading activity in Old Line stock while in possession of undisclosed material inside information during the period April through November, 1972:

(a) Bradford and Bradford, Jr. purchased in April, 1972, and sold in July and August, 1972, Old Line stock for their personal and corporate accounts, realizing during the period April through August profits in the amount of $115,000. (Bradford purchased for Life Stock in April 5,400 shares which were sold in August for a profit of $103,000, and Bradford, Jr. purchased in April 1,225 shares which were sold in July for a profit of $13,000.) In addition, Bradford also purchased in April for his wife's account 2,000 shares which had increased in value by $60,000 when sold in exchange for USLIFE shares in December, 1972. The profit on these transactions was $175,000.

(b) From April through December, 1972, Bradford & Co., on a daily basis, made purchases and sales of Old Line stock in substantial volume in its trading account as a principal market-maker of Old Line securities, realizing a profit during this period of approximately $75,000.

(c) From April until November, 1972, Bradford negotiated, contracted for and took steps to effectuate the sale of more than 60,000 of his own Old Line shares to USLIFE, receiving in December, 1972 USLIFE stock in

exchange thereof which increased the value of his investment in Old Line from April through November by more than $25 a share, or more than $1,500,000.

3. The continuous trading activity in Old Line stock by Bradford, Bradford, Jr. and Bradford & Co. as broker-dealers from April through November, 1972, during the period in which the terms of the merger were being established and the distribution put into effect, constitutes market-manipulation in violation of Rule 10b-6.

4. Each plaintiff sold Old Line stock during the period of nondisclosure and is therefore entitled to damages as a result of defendants' nondisclosure in violation of Rule 10b-5 and market-manipulation in violation of Rule 10b-6. The measure of damages is the difference between the price each plaintiff received for his shares sold during the period of nondisclosure and manipulation and the highest value reached by Old Line stock within a reasonable time after the tortious conduct was discovered and the disclosure made of the information wrongfully withheld. The highest bid value reached by Old Line stock within a period of 20 days following the SEC's action on November 10, 1972, disclosing the defendants' wrongful conduct on the SEC's action giving approval to the merger on November 20, 1972, was $58 a share reached on November 21, 1972 and on December 8, 1972. Applying this measure of damages, each plaintiff is entitled to damages as follows:

Name	Number of Shares	Date of Sale	Price Per Share	Amount Received	Difference in Amount Received and Value at $58 Per Share
Lula L. Woosley, Wm. B. Woosley and Harry L. Woosley, as Executors of the Estate of W. Bryant Woosley (Deceased)	90	6/14/72	32½	$ 2,925.00	$ 2,295.00
	112	6/15/72	33¼	3,724.00	2,772.00
	186	6/15/72	33¼	6,184.50	4,603.50
	4,000	6/15/72	32½	130,000.00	113,000.00
	2,000	6/15/72	33	66,000.00	50,000.00
	6,388			$208,833.50	$172,670.50
Lula L. Woosley	1,000	6/13/72	32½	$ 32,500.00	$ 25,500.00
	64	6/14/72	32½	2,080.00	1,581.00
	3,400	6/15/72	33¼	113,050.00	84,150.00
	4,464			$147,630.00	$111,231.00
William B. Woosley, Jr.	266	6/13/72	33½	$ 8,911.00	$ 6,517.00
	359	6/14/72	32½	11,667.50	9,154.50
	458	6/15/72	33¼	15,228.50	11,335.50
	66	6/14/72	32½	2,145.00	1,683.00
	9	6/15/72	33¼	299.00	223.00
	48	6/14/72	32½	1,560.00	1,224.00
	13	6/15/72	33¼	432.25	321.75
	1,219			$ 40,243.25	$ 30,458.75

Elizabeth M. Woosley (as custodian for children)	32	6/14/72	32½	$ 1,040.00	$ 810.00
	10	6/14/72	32½	325.00	255.00
	6	6/15/72	33½	199.50	148.50
	2	6/15/72	33¼	66.50	49.50
	50			$ 1,631.00	$ 17,069.00
Harry L. Woosley (for self and as custodian for children)	284	6/14/72	32½	$ 9,230.00	$ 7,242.00
	151	6/13/72	33½	5,058.50	3,699.00
	47	6/14/72	32½	1,527.50	1,198.00
	72	6/13/72	33½	2,412.00	1,764.00
	43	6/13/72	33½	1,440.50	953.00
	497			$ 19,668.50	$ 14,957.00
Jerry D. Fridrich	600	6/15/72	32½	$ 19,500.00	$ 15,300.00
Agnes Kim	600	6/15/72	32½	$ 19,500.00	$ 15,300.00

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In addition, on the question of damages, the court, having found liability, must provide an equitable remedy tailored to the facts. The court is of the opinion that the measure of damages set out above provides an equitable remedy because plaintiffs, having sold their stock as a consequence of the wrongful conduct of defendants, should be entitled before making a decision on the question of going back to the market and repurchasing their stock, to wait and see and make a judgment after the market situation is clarified so that a securities analyst or other expert in the brokerage field is in position to analyze the market and make a recommendation with reasonable confidence that he is in possession of the material facts affecting the price of the security. Otherwise a reasonable investor caught in this kind of market situation would be unable to intelligently determine how to mitigate his damages. This remedy gives the investor a reasonable opportunity to make up his mind respecting repurchase of the stock after the facts are disclosed and is calculated to place the investor as nearly as possible in the position he would have been in had there been no fraudulent conduct. This remedy is therefore consistent with the remedy for damages established by the Supreme Court in **Affiliated Ute** when it says that such a seller is entitled to the difference between what he received "and the fair value of what he would have received had there been no fraudulent condition." 406 U.S. at 155.

An order will be entered in accordance with this memorandum.

L. CLURE MORTON
Judge

United States District Court for the
Middle District of Tennessee
Nashville Division

Jerry D. Fridrich, Agnes Kim, W. Bryant Woosley, Harry L. Woosley, II, Elizabeth M. Woosley,
v.
J. C. Bradford, J. C. Bradford, Jr., J. C. Bradford & Co., J. C. Bradford & Co., Inc., Life Stock Research Corp.

Civil No. 7002.

ORDER

(Filed June 17, 1974)

In accordance with the Memorandum contemporaneously filed, it is Ordered:

(1) That Jerry D. Fridrich have and recover of the defendants the sum of $15,300.00;

(2) That Agnes Kim have and recover of the defendants the sum of $15,300.00;

(2) That Lula L. Woosley, William B. Woosley and Harry L. Woosley, as executors of the estate of W. Bryant Woosley have and recover of the defendants the sum of $172,670.50;

(4) That Lula L. Woosley, individually, have and recover of the defendants the sum of $111,231.00;

(5) That William B. Woosley, Jr., individually, have and recover of the defendants the sum of $30,458.75;

(6) That Elizabeth M. Woosley, as custodian for her children, have and recover of the defendants the sum of $1,269.00;

(7) That Harry L. Woosley, individually and as custodian of his children, have and recover of the defendants the sum of $14,957.50.

L. CLURE MORTON
United States District Judge

Supreme Court, U. S.
FILED
DEC 1 1976
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-605

JERRY D. FRIDRICH, ET AL.

Petitioners,

v.

J.C. BRADFORD, ET AL.

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR RESPONDENTS IN OPPOSITION

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

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ON PETITION
FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

BRIEF FOR RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The opinion delivered in the United States Court of Appeals for the Sixth Circuit is reported in [Current Volume] CCH Fed. Sec. L. Rep. at ¶95,723. The memorandum of the United States District Court for the Middle District of Tennessee is reported in ['74-'75 Transfer Binder] CCH Fed. Sec. L. Rep. at ¶94,723.

QUESTIONS PRESENTED

1. After being informed by an official of an insurance holding company that his corporation contemplated a merger offer to a life insurance company, defendants (other than J. C. Bradford & Co.) bought unlisted stock in the target company from broker-dealers selling as principals, but did not make a public announcement of the information received. Plaintiffs sold stock in the target company several weeks later. There was no contractual or other relationship between defendants and plaintiffs. Under Section 10(b) of the Securities and Exchange Act of 1934 (15 U.S. Code §78j) and Rule 10b-5 of the Securities and Exchange Commission, are defendants liable in damages to plaintiffs who sold stock of the target company six weeks after defendants' purchases but prior to the actual merger offer and its public announcement by the corporations involved?

2. Defendant, J. C. Bradford & Co., a broker-dealer, continued to make a market in the stock of the target company after two of its partners received the foregoing information. Was this defendant liable to plaintiffs under Rule 10b-6 of the Securities and Exchange Commission?

COUNTERSTATEMENT OF THE CASE

The statement of facts contained in Section I of the opinion below, reprinted at pages 3b-9b of the Appendix to the Petition,[1] is essentially correct, except that in the first full paragraph on page 5b, it is erroneously stated that Crosby, in effect, proposed to J. C. Bradford an acquisition of Old Line by USLIFE in April of 1972, and agreed to negotiate the acquisition only with Bradford. In fact, Crosby contacted Bradford at that time in order to get Bradford to propose the merger on

[1] All references to the opinion below will be by citation to pages of the Appendix to the Petition.

USLIFE's behalf to management of Old Line. Bradford at that time was neither an officer nor a director of Old Line, but had influence as a major stockholder and former director of Old Line. See Stipulations 13 through 17 reproduced at pages 25-28 of printed Appendix filed in the Court of Appeals.

The Statement of the Case in the Petition contains a number of inaccuracies in its recitation of facts. The only defendant who was a director of Old Line at any time relevant to the issues in this case was J. C. Bradford, Jr. The defendants did not control Old Line. During 1972, all of the defendants, together with members of the Bradford family and all partners and employees of Bradford & Co. owned, in the aggregate, no more than 17% of all shares of Old Line stock outstanding. J. C. Bradford himself owned approximately 5% of such stock. J. C. Bradford & Co., not J. C. Bradford, was a market maker for Old Line stock, and J. C. Bradford & Co., not J.C. Bradford, continued to make a market in Old Line stock throughout 1972. See Stipulations 7 through 11, at pages 23-24 of Appendix in Court of Appeals.

Contrary to the assertion at the bottom of page 8 of the Petition, the District Court did not find that defendants' asserted violation of Rule 10b-6 adversely affected the market. The Court of Appeals concluded, to the contrary, that there was no evidence of market manipulation (n. 13 and 15 at App. pages 10b-12b).

REASONS FOR DENYING THE WRIT

I. NO REAL CONFLICT AMONG THE CIRCUITS.

The principal ground urged by plaintiffs for grant of certiorari is a supposed conflict, on the first question presented, between the opinion below and the opinion of the Court of Appeals for the Second Circuit in *Shapiro* v. *Merrill Lynch,*

Pierce, Fenner & Smith, 495 F.2d 222 (2d Cir. 1974).[2] The factual distinctions between the two cases are so fundamental that any conflict is more apparent than real, and as Judge Celebreeze pointed out in his concurring opinion, the decision of the Sixth Circuit in the instant case could well have been based on other grounds, which would not even apparently conflict with the *Shapiro* v. *Merrill Lynch* opinion. Some of these factual distinctions and other grounds will now be pointed out:

A. Identity of persons on other side of transaction.

In the instant case, unlike *Shapiro* v. *Merrill Lynch,* the defendants knew the exact identity of the persons selling the stock defendants purchased. The purchase by J.C. Bradford for his wife was from stock owned by his own firm, J.C. Bradford & Co. The purchase by J.C. Bradford, Jr. for himself was likewise from stock owned by J.C. Bradford & Co. The purchases by Mr. Bradford for Life Stock Research Company were likewise from stock owned by J.C. Bradford & Co., with the exception of one purchase from another dealer, Bache & Co. See Stipulation 54 at page 51 of Appendix in Court of Appeals. Thus the defendants had the opportunity to disclose their information privately to the sellers without making a public announcement. Whether they did or did not do so might affect their liability to the sellers, but not to others. The decision reversing the District Court in this case might well have been placed on this ground without a discussion of the impersonal market problem. It is true that trades on the over-the-counter market may be

[2] While conflict with *Blackie* v. *Barrack,* 524 F.2d 891,906-908 (9th Cir. 1975) and *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corporation,* 426 F.2d 569 (1970), 480 F.2d 341 (1973), 516 F.2d 172 (1975) *cert. granted,* (April 5, 1976) (Nos. 75-353, 75-354, 75-355) is also claimed, the *Blackie* case involved a deception "inflating the price of stock traded in the open market," 524 F.2d 904, a circumstance which the Sixth Circuit specifically noted to be absent in this case (see Section I D at 7 *infra),* and *Chris-Craft* is distinguishable on similar grounds (see Section IV at 13 *infra*).

impersonal, as where the broker acts for an undisclosed principal; but in the instant case, the transactions were face to face and not impersonal.

As to plaintiffs' sales, they were made six weeks later to a known purchaser, A.G. Edwards and Sons & Co., Inc. and there was no connection between defendants' purchases and plaintiffs' sales. See Stipulation 59 at page 54 of Appendix filed in Court of Appeals.

B. Restitution.

In the instant case the defendants made (or offered) full restitution to all persons (including dealers) who sold Old Line stock to J.C. Bradford & Co. during the period when the other defendants were buying such stock from J.C. Bradford & Co., and also to all customers who sold Old Line stock to J.C. Bradford & Co., prior to the public announcement on June 29, 1972, made by Old Line Life Insurance Company to the effect that USLIFE had made a merger proposal (App. page 8b). The amount paid in restitution exceeded the profits of defendants (App. page 9b), realized or unrealized, so that, as pointed out by the Court of Appeals, the "impact" of the sanctions so imposed "is bound to be significant," whether or not considered to be "a sufficient vindication of the public rights and an adequate deterrent to future misconduct." (App. page 29b)

C. Confidentiality of the nonpublic information.

Plaintiffs in the instant case claim to have been damaged by defendants' breach of an asserted duty to make a public announcement of confidential information imparted to one of them by USLIFE concerning USLIFE's interest in acquiring Old Line. This duty to disclose, it is claimed, was imposed by Rule 10b-5, as applied by the Second Circuit Court of Appeals in *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833 (1968) and in *Shapiro* v. *Merrill Lynch.* Neither of these cases, however, holds that Rule 10b-5 requires an insider to breach a duty he

may have to maintain a corporate confidence. [3] In *Texas Gulf Sulphur*, which was the genesis of the so-called "abstain or disclose" rule, the Second Circuit specifically recognized that a duty to maintain a corporate confidence might foreclose any conflicting duty of public disclosure, in which case the insider's only duty is **not to trade:**

> "Thus, anyone in possession of material inside information must either disclose it to the investing public, **or, if he is disabled from disclosing it in order to protect a corporate confidence,** or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such information remains undisclosed." (Emphasis added.)
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> 401 F.2d at 848

There is no suggestion that an illegal trade removes the duty **not** to disclose.

In *Shapiro* v. *Merrill Lynch*, it was alleged that Merrill Lynch received adverse confidential earnings information concerning Douglas Aircraft Company and disclosed it to the Selling Defendants, whose massive sales caused a sharp drop in the price of Douglas Aircraft stock. Such disclosure constituted a breach of duty of confidentiality to Douglas. [4] The complaint alleged that "the defendants" defrauded plaintiffs by "withholding from them the material inside information described in

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[3] Restatement (Second) of Agency §395 (1958) provides:
"Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency. . .unless the information is a matter of general knowledge."

[4] The Statement of Policy which Merrill Lynch was required to adopt pursuant to the order entered in the SEC Broker-Dealer proceedings growing out of its Rule 10b-5 violations was fashioned "to provide more effective protection against disclosure of confidential information." Securities Exchange Act Release No. 8459 (1968).

paragraph '28' once the Selling Defendants commenced selling Douglas stock on the basis of this material inside information" and then alleged:

> "37. Although Merrill Lynch and the individual defendants [officers and salesmen of Merrill Lynch] were obligated to keep confidential the material information set forth in paragraph "28" of this amended complaint, once the said information was disclosed to the Selling Defendants, **then the defendants** were obligated to disclose this information to the general investing public..."

In the instant case, on the other hand, the information concerning USLIFE's interest in acquiring Old Line continued to be confidential throughout the period of defendants' trades, and remained confidential at the time of plaintiff's sales, six weeks later. See Stipulation 26 at pages 30-31 of Appendix in Court of Appeals. Plaintiffs are, in effect, arguing that once defendants purchased Old Line shares, a duty was imposed on them to violate their duty of confidentiality to USLIFE. The Second Circuit did not address this question. If and when it is addressed, after an evidentiary hearing, the decision may be entirely consistent with that in the instant case.

D. No price change as a result of trades as there was in *Shapiro* v. *Merrill Lynch*.

In his opinion in the instant case, Judge Engel pointed out:

> "Defendants' trading did not alter plaintiffs' expectations, and in no way influenced plaintiffs' trading decision." (App. page 22b).

And in note 27 (App. page 26b), Judge Engel cautioned,

> "We specifically do not reach the question of the availability of the remedy to open market situations where the insider trading with the resultant price changes has in fact induced the plaintiffs to buy or sell to their injury."

In *Shapiro* v. *Merrill Lynch*, on the other hand, the Second Circuit recited that defendants' sales of 165,000 shares of Douglas common during the period June 20 through June 23 amounted to almost half the Douglas shares traded during that period, and that plaintiffs purchased their shares on June 23 and June 24. The court continued:

> "Beginning about June 22 or 23, the market price of Douglas common on the NYSE took a sudden and substantial drop. **This coincided with and, according to the complaint, was caused by the substantial sales by the selling defendants on the basis of material inside information,** the disclosure of which after plaintiffs' purchases precipitated a further severe drop in the market price of Douglas common." (Emphasis added.)
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> 495 F.2d at 233

The clear implication of this allegation was that the plaintiffs were influenced to purchase by the low price of Douglas common caused by defendants' massive sales on inside information. The price of Douglas common declined from an opening price of 90½ on June 22 to an apparent bargain closing price of 78¾ on June 23, the day of plaintiffs' first purchases. 495 F.2d 233, n. 8. Public disclosure did not occur until June 24.

E. Illegal tipping and selling, as in *Shapiro* v. *Merrill Lynch*, have different consequences from illegal purchases.

The defendants in the instant case made their purchases six weeks prior to plaintiffs' sales. Where one **sells** in an anonymous market on inside information of a kind which will probably depress the market price of the stock when it is publicly announced, the potential loss is passed on and will be realized by the person who owns the stock at the time of the public announcement. This owner may have bought from the original seller or from some intermediate purchaser. The "lighted squib" case, *Scot* v. *Shepherd*, 2 Wm.Bl. 982, 96 Eng.

Rep. 525 (1773), found in tort case-books, is analogous. The "class" of plaintiffs may be an extensive one, not limited to persons who bought during the same period of the illegal sales. Contrariwise, when one **buys** on inside information of a kind which will probably enhance the market price of the stock when released to the public, no one can be injured except a simultaneous seller.

Shapiro v. *Merrill Lynch* was a case of illegal tipping and selling. The *Texas Gulf Sulphur* litigation involved illegal purchases, but the only persons held by any Circuit Court of Appeals to be entitled to recover [5] were persons who relied on a **misleading** press release. The instant case was one of allegedly illegal purchases, but no tipping (which distinguishes it from *Shapiro* v. *Merrill Lynch*) and no misleading press release (which distinguishes it from *Mitchell* v. *Texas Gulf Sulphur*).

F. Different sources of nonpublic information.

In *Shapiro* v. *Merrill Lynch*, the information about the poor earnings of McDonnell Douglas Aircraft Company came from that company and it was that company's stock which was traded. In the instant case, on the other hand, the information that USLIFE proposed to make a merger offer to Old Line came not from Old Line but from USLIFE itself, and hence was not true "inside information." See Tentative Draft No. 2, Federal Securities Code, Section 1303, Comment 10 (American Law Institute) where the following illustration is given:

> "...A was told by Z (not an insider of X Co.) that Z's family company was about to offer a huge supply contract to X Co."

The illustration concludes that "A may legally purchase X Co.'s stock."

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[5] *Mitchell* v. *Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir. 1971).

G. No finding of fact that defendants were motivated by nonpublic information.

While both the District Court and the Court of Appeals in the instant case seemed to have assumed that the defendants, in their purchasing of Old Line stock, were motivated by the information received from USLIFE, there was no finding of fact to that effect and the undisputed and unimpeached evidence was to the contrary. Immediately prior to the purchase, the research department of J.C. Bradford & Co. had issued a "buy" recommendation on Old Line stock and both Bradfords testified that their purchases were made on the merits of the stock and not on the information from USLIFE. See Stipulation 19 at page 29 of Appendix in Court of Appeals. The assumption of the District Court apparently was that persons who have intended to buy a stock become legally inhibited from so doing if material nonpublic information is thrust upon them before the purchases are made. This question was not addressed by the Court of Appeals in the instant case, but see *Ernst & Ernst* v. *Hochfelder*, 46 L.Ed. 2d 688 (1976), holding that Rule 10b-5 imposes no liability in the absence of an intent to deceive, manipulate, or defraud. It is significant that two of the plaintiffs bought their Old Line stock after defendants' purchases, on the recommendations of their broker, Mr. Schoen, who had only the same information as J.C. Bradford & Co.'s research department. (App. page 7b; see also testimony of Schoen at page 110 of Appendix in Court of Appeals.)

H. Jurisdiction.

Finally, neither the District Court nor the Circuit Court of Appeals in the instant case, nor the District Court nor the Court of Appeals in *Shapiro* v. *Merrill-Lynch*, considered the question of jurisdiction. While jurisdiction over the 10b-6 cause of action asserted against J.C. Bradford & Co., a broker-dealer registered under §15(a) of the Exchange Act, might exist under §15(b)(3) of that Act, 15 U.S.C. §78o(b)(3), such section would not provide a jurisdictional basis against the other

defendants. If the gravamen of the tort was the **failure** to make a public announcement of material information, such **failure** could not possibly be accomplished by "use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange" (15 U.S.C., §78j). "Use" is a positive, not a negative, concept, and there can be no **use** of the mails or of facilities of any kind in **failing** to make a public announcement.

Indeed, in the instant case, there was no evidence and no finding of any "use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange," even in the purchases of Old Line stock by the defendants. Obviously there was no occasion for any such "use" in the purchases by defendant from J.C. Bradford & Co., which presumably took place at one place of business by word of mouth and by paper work within that place of business. The question of such "use" in connection with purchases or sales would appear to be irrelevant, however, where the liability is predicated only upon failure to make a public announcement for the benefit of unknown persons. In *Shapiro* v. *Merrill-Lynch*, where the decision was on the pleadings, the jurisdictional allegations were apparently not challenged. In the instant case, the Court of Appeals pretermitted the jurisdictional issue, although defendants had denied the jurisdictional allegations of the complaint, and had raised the question on the appeal.

II. THIS COURT'S DECISION IN THE *AFFILIATED UTE CITIZENS* CASE WAS NOT MISINTERPRETED BY THE SIXTH CIRCUIT.

While it is urged in the petition that the Sixth Circuit's opinion rejected the causation test announced in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972), this Court specifically limited that standard to "the circumstances of [this] case," which involved "a 'course of business' or 'a device,

scheme, or artifice' that operated as a fraud upon the Indian sellers" in face to face transactions. (406 U.S. at 153.) Moreover, this Court's recent decision in *TSC Industries, Inc.* v. *Northway, Inc.*, 48 L. Ed. 2d 757 (1976) did not reaffirm the *Affiliated Ute* test in the exchange offer context, as argued in the Petition. Rather, it reaffirmed the causation test of *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 431 (1964), under which violation and injury from a material misstatement or omission in a proxy statement was established if " **'the proxy solicitation itself...was an essential link** in the accomplishment of the transaction' " 48 L. Ed. 2d at 763. If this rule is extrapolated to the Rule 10b-5 context, it is clear that there must be some essential link between an insider's purchases and another's sales (as there was in *Affiliated Ute*) in order for liability to exist. In the instant case, there is no such "essential link" and there could be none in view of the six weeks interval between defendants' purchases and plaintiffs' sales.

III. THIS CASE NOT A PROPER VEHICLE FOR FURTHER REVIEW OF RULE 10b-5.

The decision of the District Court in the instant case can be regarded only as what would in biology be called a "sport." The reversal by the Court of Appeals leaves it, we hope, without prospect of progeny. While we are sympathetic with the notion that this Court should finally put a stop to the cancerous growth of the private right of action under Rule 10b-5, we suggest that a more appropriate vehicle for so doing might well be awaited than the instant case, in which there were so many grounds for a dismissal of the complaint.

IV. THIS CASE NOT IN CONFLICT WITH THE SECOND CIRCUIT'S DECISIONS IN *CHRIS-CRAFT* v. *PIPER AIRCRAFT CORPORATION*, 426 F.2d 569 (1970), 480 F.2d, 341 (1973), 516 F.2d, 172 (1975), *CERT. GRANTED* APRIL 6, 1976 (NOS. 75-353, 75-354, 75-355).

The Court of Appeals held, with reference to the alleged violation of Rule 10b-6, that there was no evidence of market manipulation (Footnote 15, App. page 11b-12b) and no evidence that defendants' trades "caused any change in the pricing of Old Line stock or in any way influenced plaintiffs' 'decisions to sell' " (App. page 30b). *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.* is not in conflict.

V. SCHOLARLY OPINION SUPPORTS THE DECISION BELOW.

There is an abundance of scholarly authority in complete accord with the opinion of the Court of Appeals. See, e.g., Painter, *Federal Regulation of Insider Trading* (The Mitchie Company, 1968) at 149; Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code*, 72 Mich. L. Rev. 1398, 1492 (1974). Tentative Draft No. 2 of the American Law Institute's *Federal Securities Code* (1973) supports the result reached by the Court of Appeals, rather than that reached by the District Court. As pointed out above, Section 1303, Comment 10, would permit defendants to trade on the information involved here. Section 1402(f)(2)(B) would limit defendants' liability "to the extent of the securities that defendants bought or sold," and defendants have already disgorged the maximum permissible damages under that section.

Although the Petition cites Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 Harv. L. Rev. 584 (1975) as scholarly authority opposed to the opinion below, that Note does not argue in favor of applying the *Affiliated Ute* causation standard in open market situations except when fraudulent acts have actually had an effect on the securities market.

CONCLUSION

For the reasons stated, the Petition for Certiorari should be denied.

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